THE COMPASS

A QUARTERLY NEWSLETTER FROM MARTIN CAPITAL MANAGEMENT

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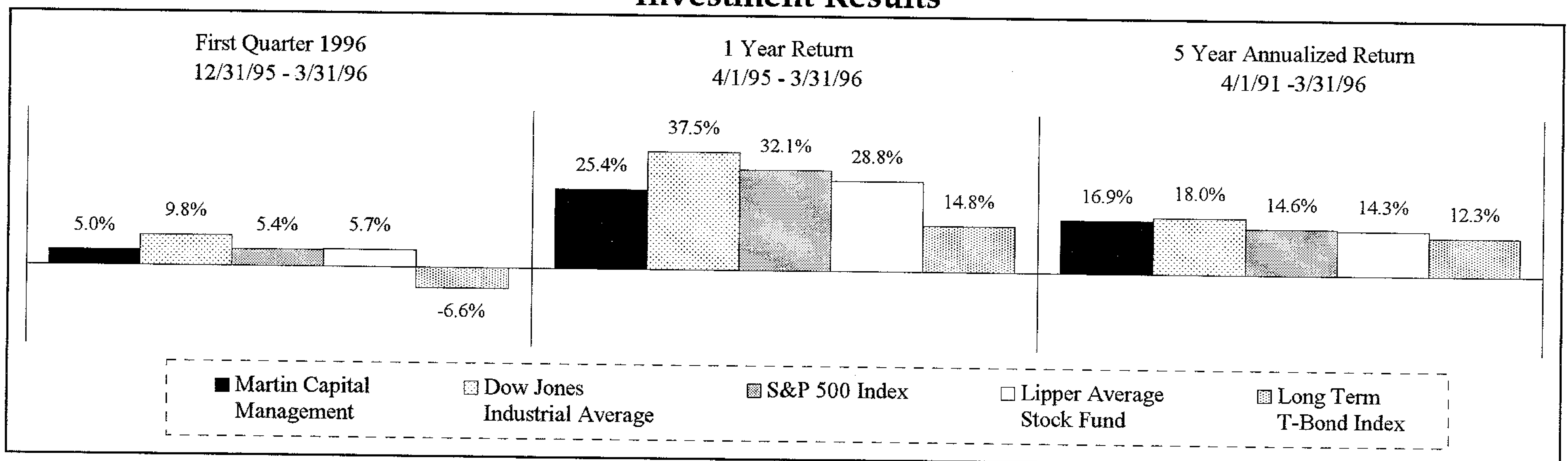
April 1, 1996

DJIA 5587.14 / S&P 500 645.50 / NASDAQ Comp. 1101.40 / Wilshire 5000 6365.89 / Long T-bond Index 6.80% (6262.74)
3 month T-Bill rate 5.00% / Federal Funds Rate 5.25% / Discount Rate 5.00% / Prime Rate 8.25% / Inflation (CPI) 2.7%
Federal Reserve Dollar Index 86.52 / Oil $21.48 / Gold $395.80 / GDP (4Q) 0.5%

Investment Results



Investment Perspective

The results were mixed for our first quarter projections. Though the average MCM portfolio exactly hit our 5% return target, the DJIA and S&P 500 outperformed our expectations, returning almost 10% and 5.5%, respectively. The NASDAQ and the Russell 2000 continued to underperform, both returning 4.7%. The Federal Reserve Board's hesitancy to lower short term rates kept the prospects for economic expansion in doubt for the first part of the quarter. Despite what we believe to be an overly aggressive inflation fighting policy, the economy recently has begun to show some signs of revival. The resiliency of the U.S. economy is more impressive than we had previously thought. Even in the face of restrictive monetary conditions, evidence of renewed economic expansion has begun to build since the end of January. As expected, the indications of economic recovery over the last half of the quarter have begun to benefit our portfolios relative to the DJIA and S&P 500. We were surprised, however, at how swiftly the bond market sold off at the mere suggestion of a possible improvement in economic growth, especially since there are few signs of an imminent resurgence of inflation.

Treasury bond rates may rise somewhat further during the second quarter as bond traders fret over the possibility that even a modest amount of economic growth, 2% to 3%, will fan the fires of inflation. This excessive pessimism is manifested in exceptionally higher than average interest rates against lower than average inflation levels. Unfortunately, the current mantra seems to be that any economic growth must eventually lead to hyper-inflation. In reality, hyper-inflation is a rare phenomenon in this country, having persisted only once in this century, from the mid-seventies to the mid-eighties. Today we have the reverse of many of the forces which drove inflation to new heights fifteen years ago. The most significant of which is the change in demographics. The intense competition for jobs amongst the baby-boom generation makes a significant increase in wages unlikely for the next twenty years. Although the government labor statistics show low unemployment numbers, we all know that there are too many people who have simply stopped looking for work, and many more who have had to take work at lower levels than they originally sought. Two thirds of inflation is related to wages. Most people are more worried about keeping their jobs than receiving higher pay. Without significant wage increases, high systemic inflation levels cannot be sustained. Eventually, interest rates should return to the 1.9% historical inflation rate premium for treasury bonds and .4% for treasury bills. Based on today's consumer price index rate of 2.7% (which the Fed says may actually be lower), treasury bonds should yield 4.6% and treasury bills should yield 3.1%.

If the Fed and the bond market's zero inflation vigilantes allow the economy to grow at a modest rate, our portfolios are well positioned to take advantage of an improvement in economic activity. We believe that the U.S. economy stabilized at the end of the first quarter, and, barring a further tightening of monetary conditions, should continue to improve as the year progresses.

Recommended Asset Allocation

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

Market Timing Viewpoint

	Three Month Performance Expectation April 1, 1996 to June 30, 1996					
	Optimistic		Most Likely		Pessimistic	
	Target	Return	Target	Return	Target	Return
DJIA/S&P 500	6150/710	+10.0%	5600/650	+00.0%	5340/610	-05.0%
T-Bond Index	6.0%	+15.0%	6.5%	+05.0%	7.25%	-05.0%

	One Year Performance Expectation April 1, 1996 to March 31, 1996					
	Optimistic		Most Likely		Pessimistic	
	Target	Return	Target	Return	Target	Return
DJIA/S&P 500	6600/775	+20.0%	6150/710	+10.0%	5830/680	+05.0%
T-Bond Index	5.25%	+25.0%	6.25%	+15.0%	7.5%	- 05.0%

20 Largest Common Stock Positions

(Prices as of March 31, 1996)

Apple Computer	24.56	Cisco Systems	46.38	Intel	56.88	Southwest Airlines	29.75
Applied Materials	34.88	Dell Computer	33.50	Micron Technology	31.63	Texas Instruments	50.88
Best Buy	17.38	Electronic Arts	26.50	Microsoft Corp.	103.13	Waterhouse Invest.	33.38
Chrysler	62.25	Hewlett-Packard	94.13	Motorola	53.00	Whole Foods Mkt	18.25
Cirrus Logic	18.06	Home Depot	47.75	Schwab (Chas)	25.88	Williams-Sonoma	22.75

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

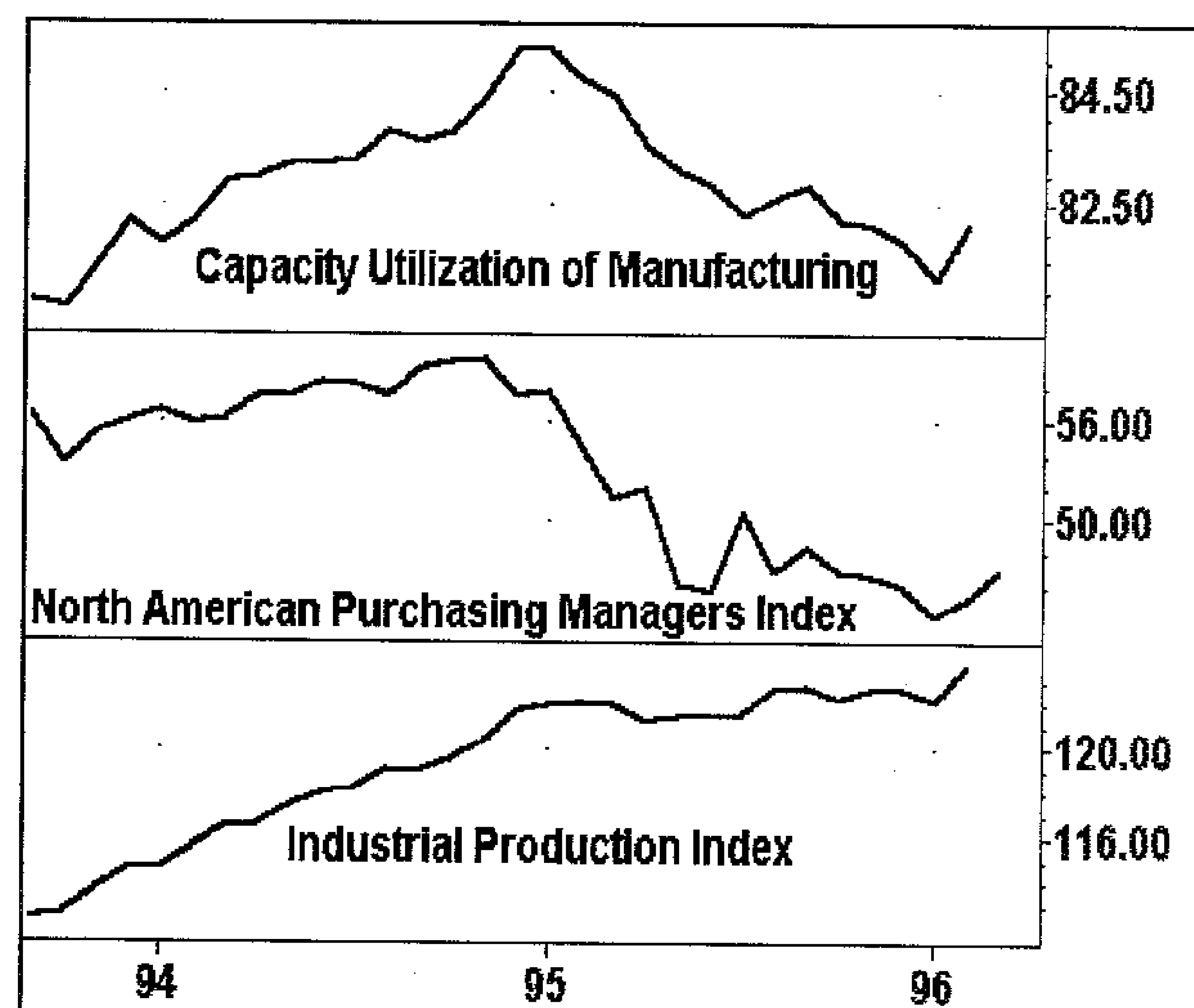
Market and Economic Statistics as of Close on March 29, 1996, with 3-month & 12-month % Changes

Stock Indexes		3 mo	12 mo	Interest Rates		3 mo	12 mo	Economy, Inflation		3 mo	12 mo
Dow Industrials	5587	9.2%	34.4%	T-Bond Yld	6.68%	12.3%	-10.1%	GDP - 4th Qtr	6776.5	0.5% apr	1.3%
S&P500	646	4.8%	28.9%	T-Bill 91 Yld	5.00%	1.0%	-12.7%	CPI, Feb.	155.0	3.1% apr	2.7%
NYSE Comp Ind	347	5.3%	28.0%	Prime Rate	8.25%	-2.9%	-8.3%	PPI, Feb.	129.7	3.1% apr	2.0%
NASDAQ	1101	4.7%	34.8%	Fed Disc Rate	5.00%	-4.8%	-4.8%	Gold - H&H	396.35	2.5%	1.4%
Wilshire 5000	6366	5.1%	29.4%	Fed Funds Trgt	5.25%	-4.5%	-12.5%	WTx IC Oil -KR	21.50	10.4%	12.2%
Russell 2000	331	4.7%	26.8%	FNMA 30yr mtg	7.91%	10.6%	-8.4%	CRB Fut Ind	251.40	3.4%	7.9%

The 3 month vs. 12 month percent changes of interest rates show a reversal of the downward trend in rates over the past year: rates are much lower now than a year ago, but some are higher than 3 months ago. GDP grew a fairly anemic 0.5% annual rate in the 4th quarter of 1995, the last measured. Estimates for GDP in the 1st quarter of 1996 vary between 1% and 2%. Retail and wholesale inflation (CPI and PPI) have remained low, both over the past quarter and the past year. The PPI actually declined 0.2% in February. Commodity prices in general have not presented a problem except in a couple of specific cases: oil and grains. Grain prices have increased steadily over the past year to historically high levels, and have had a big impact on the CRB Futures Index.

The condition of our economy seems to be one of having bumped along the bottom, but now showing some signs of a lift-off taking place. These signs are tentative and come in some cases from data that is less reliable than usual because of government shutdowns. As the economy's growth is uneven and conditions vary between sectors, it is best to examine some of these individually.

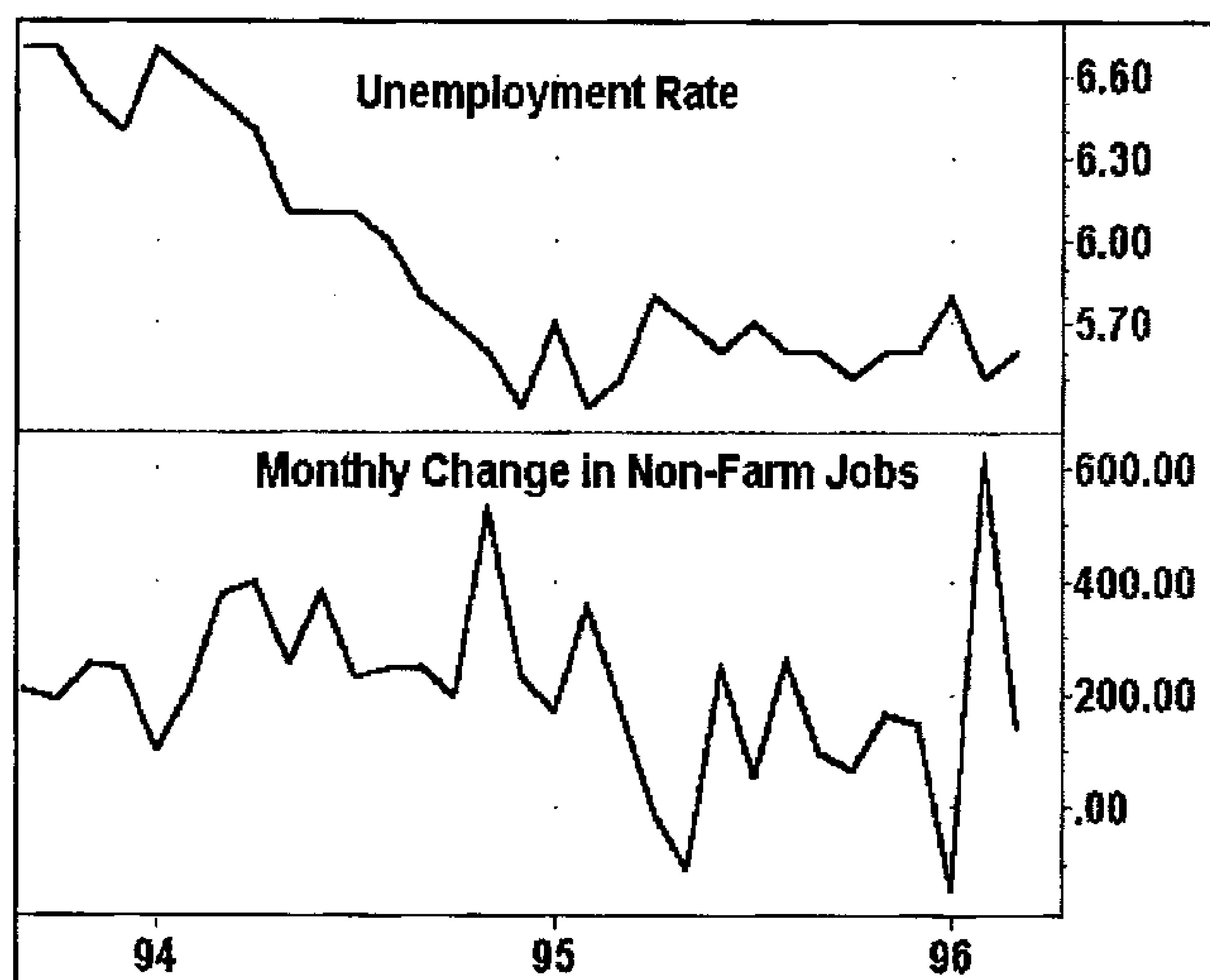
MANUFACTURING has been weakening from early 1995 until February 1996, as shown in the charts to the right. Early last year, capacity utilization of factories and equipment in industry began to drop as increased capacity and slowing orders began to idle equipment. The North American Purchasing Managers Index began to fall then in response to deteriorating conditions in areas including orders, production, costs and inventories. A reading below 50 for this indicator implies contraction taking place in the manufacturing sector. The Index of Industrial Production also flattened out starting in January of last year, and showed a very low growth rate for all of 1995. Last month, however, data for February was released that showed a reversal in all 3 of these indexes. Industrial production jumped 3% in February to the highest level since 1987. If the latest data are not due to some statistical aberration, manufacturing may have passed the low point for this cycle. New orders for factories and for durable goods both picked up in the months of December and January, and tend to confirm the turnaround in the indexes above. Most recently, durable goods orders fell in February, mostly due to aircraft, which had been very strong over the past year.



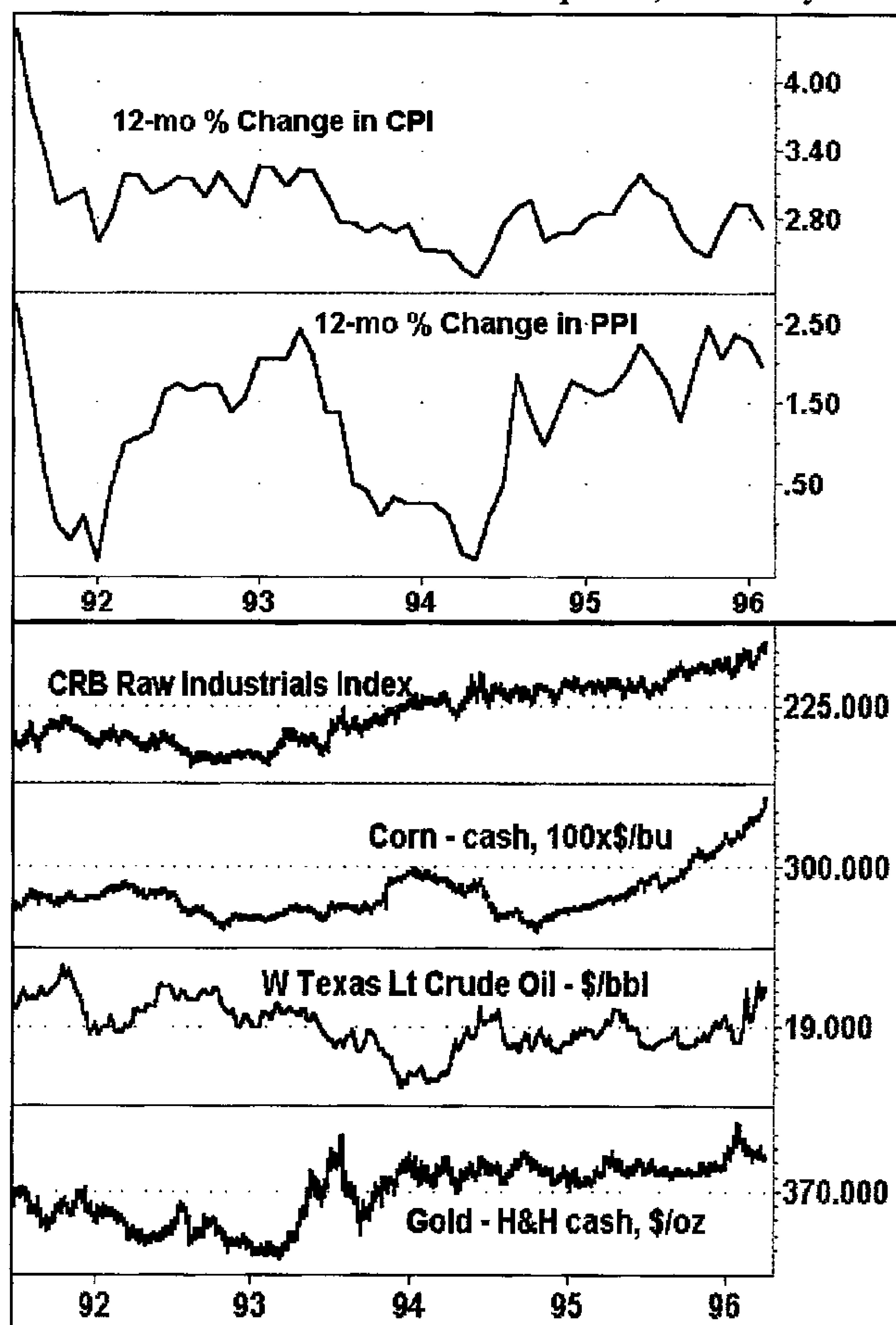
RETAIL SALES rose 0.8% in February after a January decline related to horrible weather. A large portion of this increase was due to auto sales, perhaps spurred by deals made to reduce high inventories. Retail sales and personal consumption appear to be leading their portion of the GDP toward a higher level for the 1st quarter of 1996, perhaps an increase of 1.5% - 2.0%. February showed the highest rate of housing starts in a year. Existing home sales were up 6.5% in February after a decline of 3.9% in January related to bad weather. There has been a 12 month increase of 12.7% in existing home sales, helped by lower interest rates. Consumer sentiment, as measured by both the Consumer Sentiment Index and the Index of Consumer Confidence declined slightly from early 1995 until February and March of 1996, when there was a slight rebound. A positive attitude on the part of consumers is generally viewed as good for the economy. Feelings of security are necessary for individuals to step up to the counter and spend money, particularly for big-ticket items. A source of worry for future sales is consumers' ability to continue buying when levels of credit card debt and consumer installment credit are already very high. The latest figure on credit card delinquencies was 3.34%, the highest rate in 4 years. One also has to wonder now about how strong home sales will be with higher mortgage rates.

LABOR MARKET conditions had the biggest single effect on the bond market during its recent decline. When February non-farm payrolls were reported to have jumped by 705,000, and the unemployment rate dropped from 5.8% to 5.5%, the bond market had a one day drop of a magnitude not seen since August 1990, when Iraq invaded Kuwait. (see charts on next page) There had been a sense that the economy was gaining strength, indicated by improvements in retail sales and other areas before that news appeared.

That big an increase in jobs, however, meant that a *STRONG* recovery was under way, reversing the trends toward a weakening economy in late 1995. As strong recoveries are associated with inflation sometime in the future, and hopes suddenly vanished of the Fed lowering rates, bond prices really got smashed. Manufacturing employment was up 26,000 in February, reflecting the return of employees from weather-related cutbacks. Despite this increase, factory employment was still down by 49,000 since December and down 267,000 since its recent peak of March 1995. Auto manufacturers brought back only part of the workforce that was laid off in January due to high inventories. Thus, manufacturing seems to be the hole in the doughnut for an economic recovery, both in terms of jobs and production levels.



INFLATION is not a problem in our economy today. The Consumer Price Index continues to increase at a rate of about 2.5 to 3.25% per year, and has not increased faster than that since 1991. Increases in the Producer Price Index of wholesale prices, have stayed under 2.5% since 1991. Commodities prices are a very mixed bag in terms of which prices are rising and which are falling. Raw industrial materials prices, reflected by the CRB Raw Industrials Index, have been falling as a group since mid-1995. This decline is connected to the softness in the manufacturing sector, which has been using fewer materials as production flattened and slowed. Grain prices have been the only group that has rocketed to historic highs. Although wheat and soybeans have seen huge price increases, corn has left everything behind. Poor corn harvests combined with strongly increasing demand from developing countries like China has driven prices through the roof. As workers earn more in developing countries, they will spend more for better food as part of an improved standard of living. Corn is being to fed to chickens, pigs and cattle that eventually are processed and included in a diet more interesting and nutritious than just basics like rice and beans.



Oil prices have increased rapidly during the past 2 months, partly because stocks of oil in the US were drawn down by an unusually cold winter. Then, supplies were replenished slowly in anticipation of Iraqi oil coming on the market, which was expected to soften prices considerably. Iraq didn't reach an agreement with the UN to sell oil, so now there is a big scramble to get supplies in a market that is unexpectedly tight. This situation should even out somewhat over the next few months and prices drop by a dollar or two.

Pulling together all the pieces of the economic puzzle, we see a picture of economy with a little more zip than in the last quarter of 1995, but without the strength to really take off. Manufacturing is still a weak area. Consumer retail and home sales have picked up, but levels of consumer debt are very high, likely restricting future sales somewhat, and higher mortgage rates may hamper home sales. The unemployment rate dropped and number of non-farm jobs jumped up, meaning that there will be more consumers with money to spend. Most commodity prices are not rising, although the higher prices for grain affect everyone when they buy food. Also, grain prices contribute significantly to the widely watched CRB Futures Index, and their increases acting on the index can have an exaggerated effect on the perception of inflation. Oil prices, which potentially have a much greater effect on inflation, will most likely subside soon and cease to be a leading inflationary factor over the next year.

This economic environment of low growth and low inflation is one in which it is hard to see justification for the sharp increase in long interest rates that has occurred over the past 6 weeks. In addition to the fundamentals, politics have also played a role: the failure of a balanced budget deal also contributed to higher rates. The Fed Open Market Committee chose to leave rates alone when they met in March, a result of mixed signals from the economy of some strength and some weakness. Also, the Fed governors were probably uncertain about whether the recently released economic data was reliable and correct, particularly the huge increase in the number of jobs. I suspect that the strength, particularly in the area of jobs, has been overstated and that a strong chance remains of more Fed rate cuts after a few months when numbers are more reliable and the picture is clearer. The restrictive Fed monetary policy is holding back the economy and will probably keep GDP growth below an annual rate of 2% as long as it remains in place.