THE COMPASS

A QUARTERLY NEWSLETTER FROM MARTIN CAPITAL MANAGEMENT

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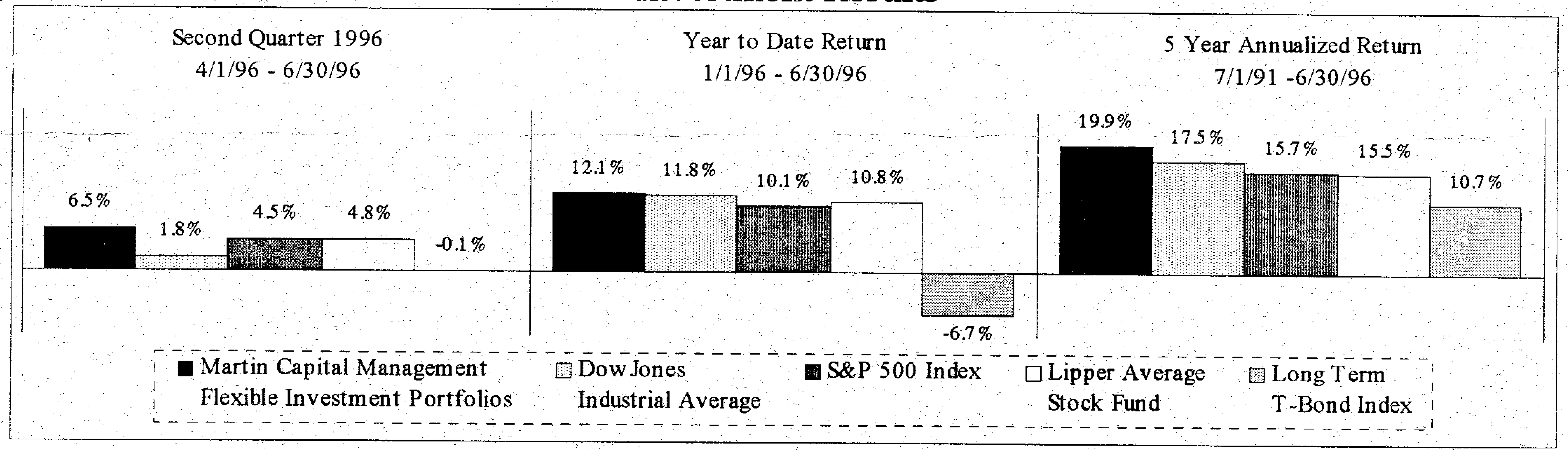
July 1, 1996

DJIA 5654.63/ S&P 500 670.63 / NASDAQ Comp. 1185.02 / Wilshire 5000 6612.77 / Long T-bond Index 7.00% (6256.83)
3 month T-Bill rate 5.04% / Federal Funds Rate 5.25% / Discount Rate 5.00% / Prime Rate 8.25% / Inflation (CPI) 2.9%
Federal Reserve Dollar Index 87.82/ Oil $20.93 / Gold $380.10 / GDP (1Q) 2.2%

Investment Results



Investment Perspective

Stock market performance figures for the second quarter were in line with our projections. Signs of further economic strength benefited our economically sensitive portfolios. Half-way through the quarter our average portfolio was up about 15%. As discussed in the mid-quarter review, our expectation of a pullback into the end of the quarter unfortunately materialized in the loss of a good portion of our quarterly gains, finishing with an average 6.5% return (near the middle of our 5% to 10% target). After surging to a 7.25% yield, Treasury bonds closed the second quarter at 7.0%, well above our 6.5% forecast. Once again, fears of economic growth contributed to much higher than normal interest rates relative to inflation.

Paraphrasing our last newsletter, Treasury bond rates may rise somewhat further during the third quarter as bond traders fret over the possibility that a moderate amount of economic growth, 3% to 4%, will fan the fires of inflation. While second quarter GDP may turn out to be in the 3% to 4% range, we believe that as the third quarter progresses economic strength will wane due to constrictively high interest rates. In our opinion the die is already cast at current interest rate levels for weaker third quarter GDP. The question now is how much higher rates may go before the financial markets begin to perceive impending economic weakness. Our guess is not much higher - perhaps 7.5% on the long bond and 5.5% on Fed Funds. Therefore, we anticipate some additional stock market weakness during the first part of the quarter. During the latter part of the third quarter, as interest rates begin to drop again, we'll probably make back most if not all of the earlier losses to roughly break even by the end of the quarter. By the fourth quarter we expect Treasury bond rates to stabilize around 6% to 6.5% and Fed Funds to be around 5% or less. Our portfolios should have their best performance of the year in the fourth quarter as the stock market begins to anticipate economic improvement again during the first part of the new year. Accordingly, we will maintain our current asset allocation in preparation for the next leg up in the economic cycle.

Recommended Flexible Asset Allocation

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

It has been heartening to finally hear a few economic commentators begin to question the widespread belief that modest levels of economic growth combined with apparently low unemployment must lead to high inflation. As time goes by more economists will appreciate that in a global economy where the U.S. is primarily a service provider, higher economic growth and lower unemployment levels can be sustained with reduced inflationary consequences. As the greatest bull market of the century unfolds, one of the factors pushing it higher will be the transformation of inflation paranoia to growth euphoria. As this occurs over the next decade Treasury bond rates may fall below 4% and GDP growth above 4% may become the norm for the U.S. in a burgeoning global economy.

Market Timing Viewpoint

Three Month Performance Expectation
July 1, 1996 to September 30, 1996

	Optimistic		Most Likely		Pessimistic	
	Target	%Change	Target	%Change	Target	%Change
DJIA/S&P 500	6000/700	+05.0%	5600/650	+00.0%	5000/600	-10.0%
T-Bond Index	6.3%	+10.0%	6.6%	+05.0%	7.50%	-07.0%

One Year Performance Expectation
July 1, 1996 to June 30, 1997

	Optimistic		Most Likely		Pessimistic	
	Target	%Change	Target	%Change	Target	%Change
DJIA/S&P 500	6800/800	+20.0%	6500/775	+15.0%	6000/700	+05.0%
T-Bond Index	5.50%	+20.0%	6.25%	+10.0%	7.50%	- 07.0%

20 Largest Common Stock Positions

1 Dell Computer	50.88	6 Whole Foods Mkt	26.50	11 Applied Materials	30.50	16 Cirrus Logic	17.50
2 Schwab (Chas)	24.50	7 Best Buy	23.00	12 Motorola	62.75	17 Williams-Sonoma	23.63
3 Hewlett-Packard	99.63	8 Electronic Arts	26.75	13 Texas Instruments	49.88	18 Oracle Systems	39.44
4 Cisco Systems	55.63	9 Southwest Airlines	29.13	14 Chrysler	62.50	19 Office Depot	20.25
5 Intel	73.44	10 Microsoft Corp.	120.13	15 Home Depot	54.00	20 Apple Computer	21.00

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
1991	+ 36.0%	+ 24.5%	+ 30.6%	+ 34.2%	+ 18.5%	+ 5.2%	+ 3.1%
1992	+ 27.3%	+ 8.0%	+ 7.7%	+ 9.0%	+ 8.0%	+ 3.3%	+ 3.0%
1993	+ 14.5%	+ 8.1%	+ 10.0%	+ 11.3%	+ 16.9%	+ 2.5%	+ 2.7%
1994	- 2.0%	+ 5.9%	+ 1.3%	- 0.1%	- 7.6%	+ 2.4%	+ 2.7%
1995	+ 27.5%	+ 36.9%	+ 37.6%	+ 36.5%	+ 30.7%	+ 2.9%	+ 2.6%
Total**	+147.7%	+130.1%	+115.6%	+121.9%	+ 80.7%	+ 17.3%	+ 14.9%
Avg. ***	+ 19.9%	+ 18.1%	+ 16.6%	+ 17.3%	+ 12.6%	+ 3.3%	+ 2.8%

* Total Annual Performance, net of commissions, fees, and expenses, of all Martin Capital Management flexible investment portfolios.
** Total compounded return, including reinvestment of dividends and interest.
*** 5 year annualized return (1991 - 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

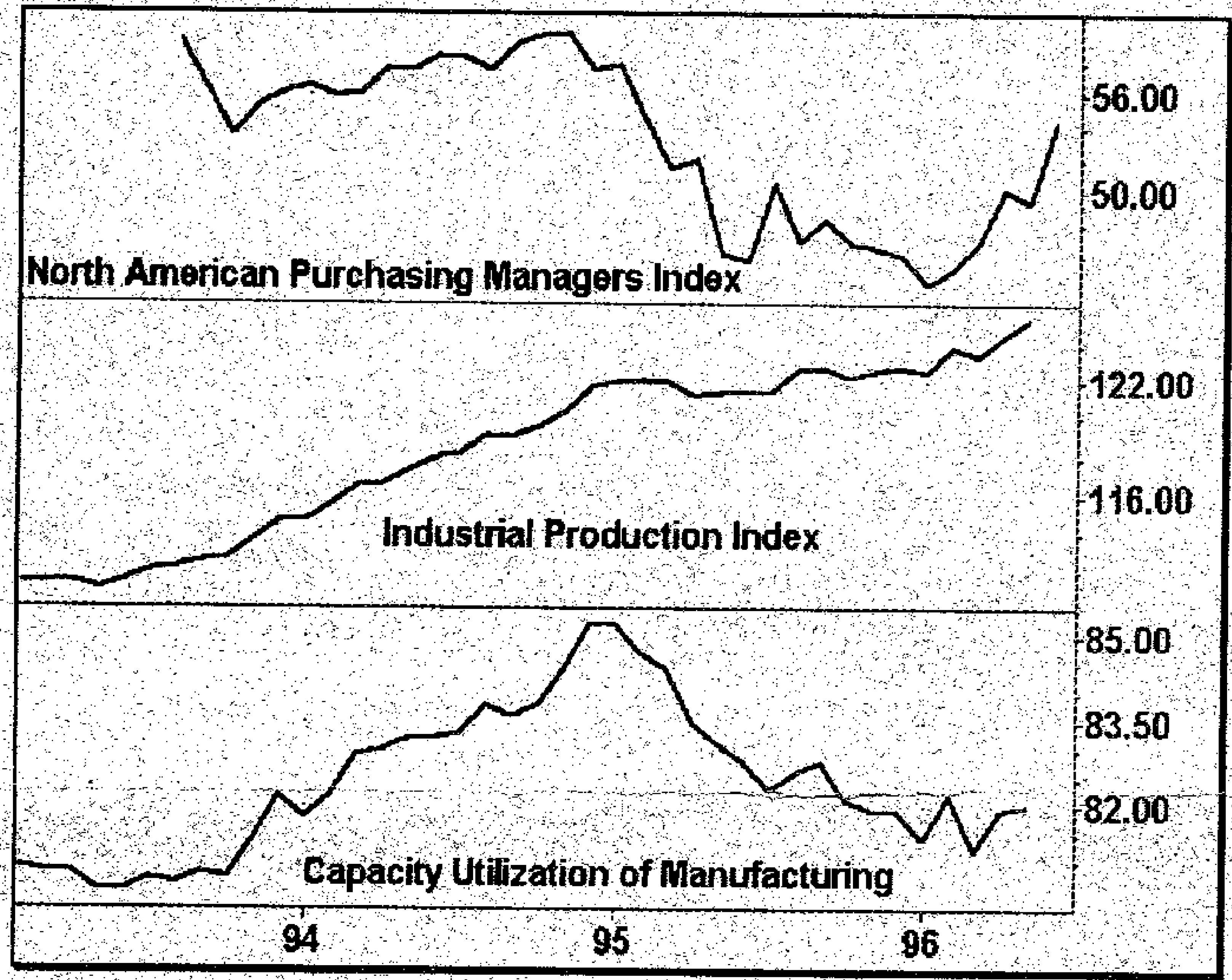
Market and Economic Statistics as of Close on June 28, 1996, with 3-month & 12-month % Changes

Stock Indexes		3 mo	12 mo	Interest Rates		3 mo	12 mo	Economy, Inflation		3 mo	12 mo
Dow Industrials	5655	1.2%	24.1%	T-Bond Yld	6.89%	3.1%	4.1%	GDP, 1st Qtr	6812.7	2.1% apr	1.7%
S&P500	671	3.9%	23.1%	T-Bill 91 Yld	5.04%	0.8%	-8.0%	CPI, May	156.7	4.4% apr	2.9%
NYSE Comp Ind	359	3.5%	23.1%	Prime Rate	8.25%	0.0%	-8.3%	PPI, May	130.8	3.4% apr	2.3%
NASDAQ	1185	7.6%	27.0%	Fed Disc Rate	5.00%	0.0%	-4.8%	Gold - H&H	380.20	-4.1%	-0.9%
Wilshire 5000	6613	3.9%	23.6%	Fed Funds Trgt	5.25%	0.0%	-12.5%	WTx IC Oil	20.84	-3.1%	19.8%
Russell 2000	347	4.8%	22.2%	FNMA 30yr mtg	8.19%	3.5%	4.5%	CRB Fut Ind	248.67	-1.1%	6.6%

The 3-month and 12-month changes in interest rates shown above are snapshots that don't tell the whole story. Not apparent in these numbers is the rise in the T-Bond yield from 5.94% in early January to 7.19% in mid-June, a 21% increase that took place between the two measuring points. The rise in long interest rates has been in response to an economy growing somewhat faster than expected. The fourth quarter of 1995 came in at a slow 0.9% rate of GDP growth, but the preliminary estimate of first quarter growth came in much stronger at 2.8%. The final revision for first quarter GDP growth was down to 2.14%. This decrease was a relief to inflation hawks, but old news by the time it arrived.

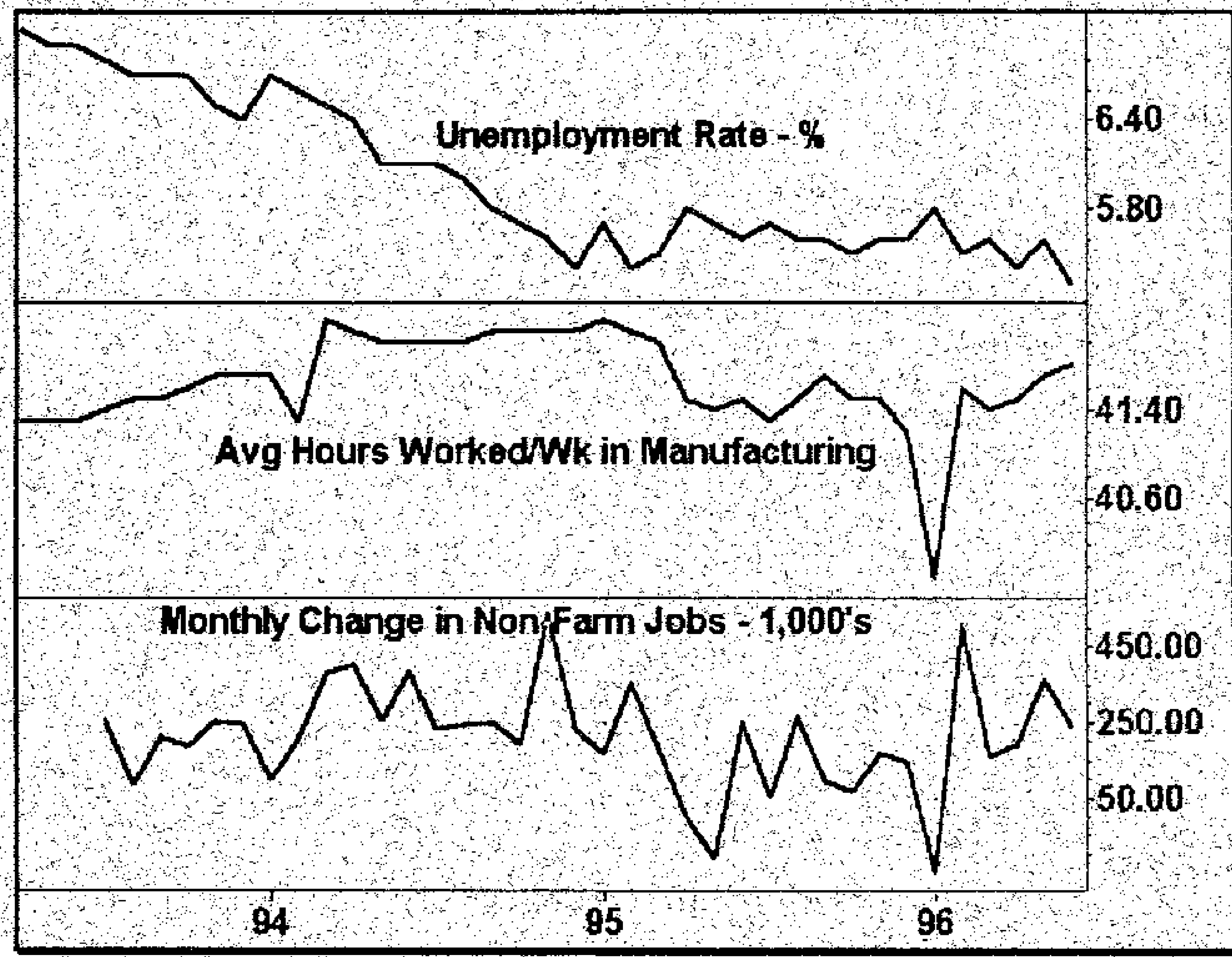
Other noteworthy figures above are the CPI changes, up over the past 3 months primarily due to oil prices rising sharply in April and May, before a subsequent decline. That sharp peak in oil prices is also outside the 3-month snapshot. Another sharp peak and decline was that of the CRB futures Index. The rise and fall in this index of commodities prices was the result of volatility in the grain markets that has subsided over the past 6 weeks, following the planting of crops.

MANUFACTURING The North American Purchasing Managers and Industrial Production Indexes clearly show an upturn shortly after the beginning of 1996. The stronger than expected first quarter GDP increase is partly a reflection of the strength shown in manufacturing. The NAPM Index has shown the strongest recovery, rising from a January level of 44.2 that was so low it generated fears of a recession. It is now up more than 10 points to 54.3 in June, a surprise to many. The lack of a big increase in capacity utilization shows that industrial capacity is not being strained and the likelihood of bottlenecks in production are unlikely. This is good news because such bottlenecks are one kind of constriction that leads to inflation. Manufacturing inventories declined by 0.2% and factory orders increased by 1.9% during May. Durable goods orders were up 3.3%, over double what was expected. New home sales rose by 7.5% in May, the largest monthly increase in 10 years. In summary, much of the manufacturing data points in the direction of increasing strength in our economy.



SALES Following a turnaround in February, retail sales have risen steadily over the last 4 months at an average rate of 6.0% on a year/year basis. May actually showed the smallest increase at 5.5%. Sales of durable goods have increased at an even faster average rate of 9.5% per month over the past 4 months. Autos have been major beneficiaries of this kind of consumer spending, as they were up 8.4% in May from a year earlier. New home sales also showed strength, with an annualized increase of 7.5% in the month of May; April had increased by 5.9%. There had been a general expectation that higher long interest rates would slow down the housing market as mortgages payments increased, but that has not proved to be the case so far. Since February, total consumer spending is up an average of 2.9% per month on a year/year basis. Consumer spending for durable goods, in line with durable goods sales figures above, has been up more at an average of 8.2%/month on a year/year basis since February. Over the four month period of February through May, retail sales and consumer spending show a clear, constant and continuing trend upward.

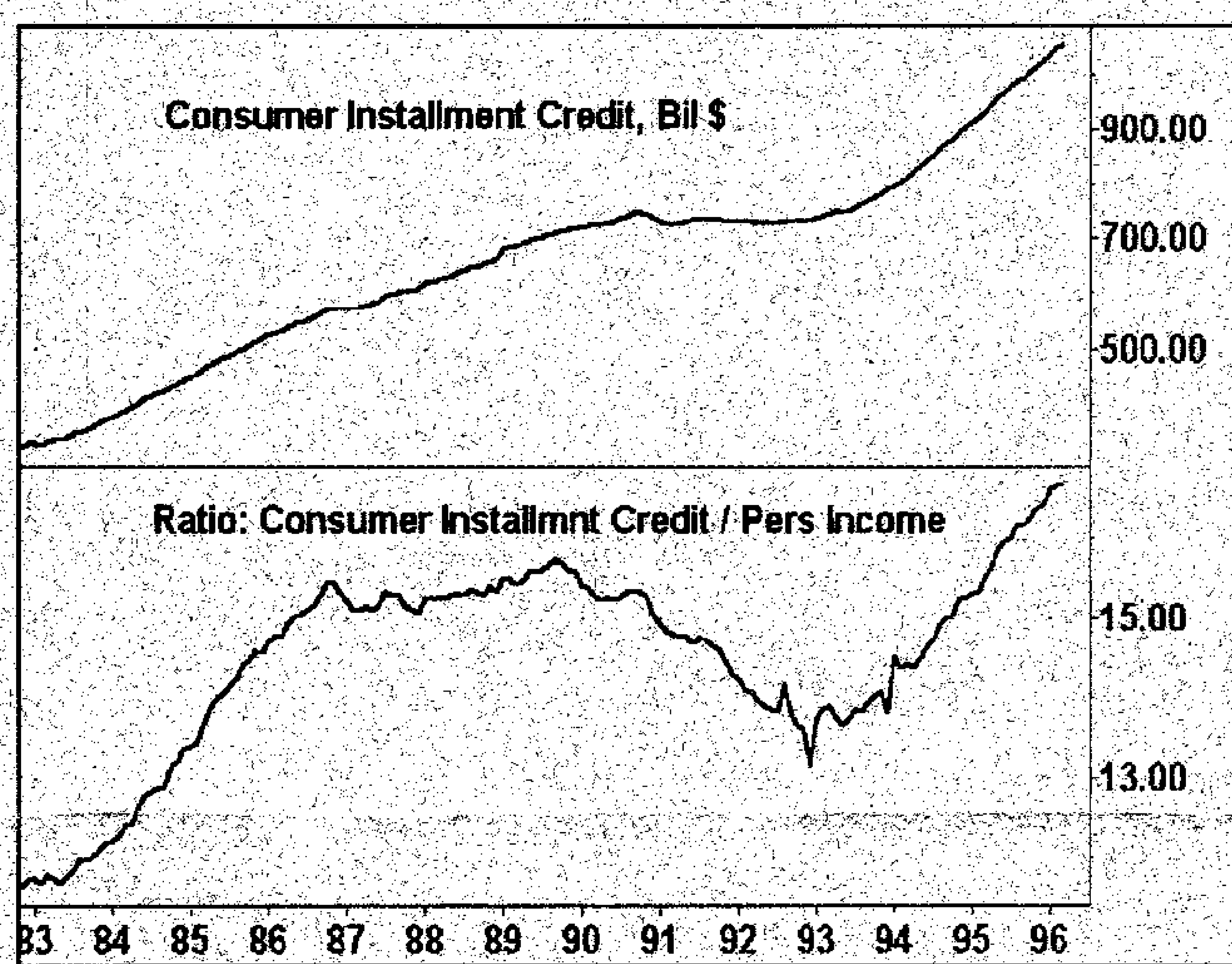
LABOR The labor market report for June was a shocker for the financial markets. The national unemployment rate dropped from 5.6% to 5.3%, the lowest rate since June, 1990. The rise in wages, 9 cents/hour was the biggest increase in the history of the Bureau of Labor Statistics and it had a big impact on the financial markets. (The effects of inflation on 9 cents must be considered, but it is still a large increase.) Weekly wages increased by $8.98/week, a year/year increase of 4.3%. If you subtract the 2.9% annual increase in the CPI from the increase in weekly wages, the real increase is only 1.4%, hardly a bonanza for wage earners. The middle chart at left shows the average hours worked per week in manufacturing, an indication of tightness in the labor market. It is now at a 14-month high, although it remained at even higher levels during most of 1994. The downward spike is the result of the blizzard last January. The bottom chart shows the average change in the number of non-farm jobs. This is a 4-week moving average of the weekly change in number of jobs. Excluding January, the trend seems to be pretty clearly upward. All in all, the data from the labor market tends to support the idea that the economy has been growing in strength since the beginning of the year.



INFLATION We do not have a problem with inflation in our economy today, as the 12-month change in the Consumer price index remains under 3%. This is probably the most widely accepted measure of inflation, and it has not risen above 3.5% since mid-1991. The recently released figures on jobs numbers and wages have given the markets and probably the Fed a bit of a scare because we have become accustomed to very slow increases in the real cost of labor. Using 1982 as the benchmark of 100 for hourly wages adjusted for inflation, the latest level is only up to about 107. We have become a part of a world labor market and whatever work can be done in factories or in homes more cheaply elsewhere is being done there. Services and government must remain here, but most manufacturing jobs in this country have to compete with a lower wage scale or be lost. In the long run, this competition will keep labor costs from rising rapidly enough to have a big impact on inflation.

Commodity prices are not a threatening factor for inflation. Grains seem to have peaked out about 6 weeks ago. Prices of industrial metals like copper, aluminum and nickel continue a general decline. Oil has risen, but not dangerously so. Gold, the most widely regarded inflation hedge, has fallen to about $380/oz., about in the middle of the range it has occupied since early 1993.

CREDIT The conditions of consumer credit are unusual enough to deserve a separate section in this economic report. Consumers have been borrowing more and more, so that consumer installment credit has increased to more than $1 Trillion. The last ratio available of consumer installment credit to personal income was at an all-time high of 16.7%. The number of credit card delinquencies is approaching a 15-year high at 3.54%. Home mortgage delinquencies and foreclosures are also on the rise across the nation. Although people may let their credit cards go unpaid from time to time, they really have to be having serious problems if they don't make their home mortgage payments. The growth of credit has helped propel the economy, but it can't keep rising like this forever. This is clearly a problem, and it will have a dampening effect on future growth in the economy.



SUMMARY Estimates of GDP growth in the second quarter have ranged from 2 to over 4% on an annualized basis, stronger than most economists expected. The rate is almost certainly above what the Fed considers acceptable, and will probably be a factor in the Fed's Open Market Committee meeting next month when rate increases are discussed. The strong labor market report has made a big impression on those who fear that 1970's style inflation is just around the corner and ready to come roaring back. While the unemployment rate is low, there are many people who have become discouraged and quit looking for work. These people are being ignored by those doing the counting, as are the people who are underemployed – those with good educations who can only find menial work. Additionally, there is the restraining factor of overseas competition in the labor market mentioned above. While labor can have a very big effect on inflation, the latest jobs numbers are not anything to panic over. Nevertheless, the Fed and most economists have been closely watching the labor market as the unemployment rate has remained below 6% since late 1994. Fed Chairman Alan Greenspan stated last December that the tight labor market and the possibility of rising wages were a source of concern about inflation in the near future. The Fed will most likely respond by raising rates in August in order to slow what they perceive to be an overheated economy and make a preemptive strike against inflation. The high level of consumer debt will act as a constraint on the economy because more personal income will have to go toward debt service rather than for purchases. Long interest rates, which have been rising since February, will also have a slowing effect. Assuming the Fed raises short rates, we should see a slowing economy by late this fall as all of these forces start to have an effect.