THE COMPASS

A QUARTERLY NEWSLETTER FROM MARTIN CAPITAL MANAGEMENT

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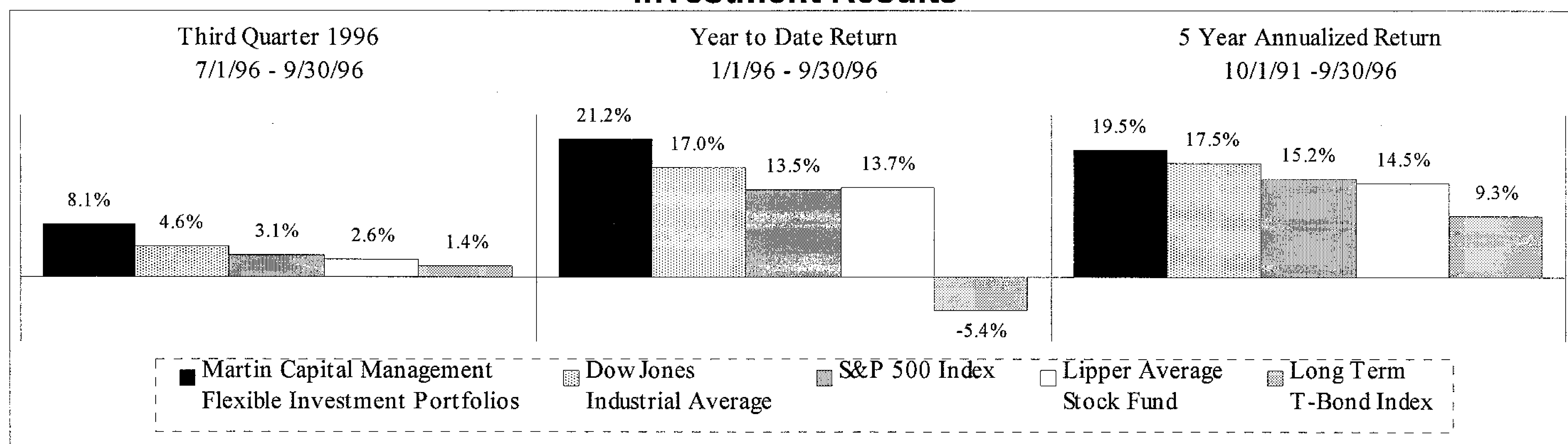
October 1, 1996

DJIA 5882.17 / S&P 500 687.31 / NASDAQ Comp. 1226.92 / Wilshire 5000 6765.65 / Long T-bond Index 7.02% (6344.45)
3 month T-Bill rate 4.91% / Federal Funds Rate 5.25% / Discount Rate 5.00% / Prime Rate 8.25% / Inflation (CPI) 2.9%
Federal Reserve Dollar Index 87.94/ Oil $24.38 / Gold $377.70 / GDP (2Q) 4.7%

Investment Results



Investment Perspective

The financial markets performed in line with our expectations throughout the third quarter. As anticipated, both stocks and bonds began the quarter with a continuation of the downtrend established in the latter half of the second quarter. The capitulation sell off in the stock market in July and the bond market rout in August and early September established major bottoms. By the end of the quarter both markets had rebounded as predicted in the previous newsletter - "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." Fortunately, we did better on average than the market indexes, returning 8.1%.

As discussed in the last newsletter, we believe that the economy began to slow in the third quarter and will continue to deteriorate in the fourth quarter. Contrary to the opinion of most economists, the Federal Reserve Board's next move should be to lower interest rates sometime around the end of the year or early next year as the economy achieves its third touch and go landing in as many years. Quoting our last newsletter: "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."

"Bull markets climb a wall of worry" is an old Wall Street adage. Everyone has very good reasons today for why the financial markets cannot keep going higher. Dividend yields are too low, corporate earnings are in question, the current economic expansion is overdue for a recession, the labor force is "too tight", oil prices are rising, higher inflation is waiting in the wings, and on and on. There are certainly plenty of worrisome issues before us today, but they are mere distractions from the tremendously positive big picture for U.S. financial markets. First, demographics are more positive today than they have been since the end of World War II. Baby boomers have to compete for jobs and they have to save for retirement - thus contributing to lower inflation pressure from wages and greater financial market liquidity. Second, we're in the nascent stages of the world's first truly global economy. Companies now have more markets in which to expand and stronger rivalry for market share - thus producing greater growth opportunities and the lower inflation benefits of price competition. Third, technological advances are enhancing productivity at such a rate that it cannot be properly quantified - again contributing to higher growth and lower inflation into the foreseeable future. Just as the most successful companies warrant higher valuations, today's exceptionally beneficial macro-economic conditions warrant higher financial market valuations.

Recommended Flexible Asset Allocation

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

Market Timing Viewpoint

	Three Month Performance Expectation October 1, 1996 to December 31, 1996					
	Optimistic		Most Likely		Pessimistic	
	Target	%Change	Target	%Change	Target	%Change
DJIA/S&P 500	6500/750	+10.0%	6200/730	+05.0%	5600/645	-05.0%
Nasdaq	1500	+20.0%	1350	+10.0%	1150	-05.0%
T-Bond Index	6.0%	+15.0%	6.3%	+10.0%	7.00%	+00.0%

20 Largest Common Stock Positions

#	Stock	Price	#	Stock	Price	#	Stock	Price	#	Stock	Price
1	Dell Computer	77.75	6	Hewlett-Packard	48.75	11	Cirrus Logic	20.88	16	Southwest Airlines	22.88
2	Intel	95.44	7	Whole Foods Mkt	26.50	12	Williams-Sonoma	28.25	17	Motorola	51.50
3	Schwab (Chas)	23.00	8	Best Buy	22.75	13	Applied Materials	27.63	18	Chrysler	28.63
4	Cisco Systems	62.00	9	Microsoft	131.88	14	Home Depot	56.88	19	Oracle Systems	42.56
5	Electronic Arts	37.38	10	Texas Instruments.	55.13	15	CompUSA	54.00	20	Office Depot	23.38

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%	+ 18.1%	+ 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
QUARTERLY ECONOMIC REVIEW

by Alston Boyd

Market and Economic Statistics as of Close on September 30, 1996, with 3-month & 12-month Changes

Stock Indexes*		3 mo	12 mo	Interest Rates		3 mo	12 mo	Prices, Inflation		3 mo	12 mo
Dow Industrials	5882	4.0%	22.8%	91-day T-Bill DR	4.91	-2.6%	-6.8%	CPI, Aug	157.40	1.8% apr	2.9%
S&P500	687	2.5%	17.6%	30-yr T-Bond Yld	6.92	0.4%	6.5%	PPI, Aug	131.40	1.8% apr	2.8%
NYSE Comp Ind	367	2.3%	17.3%	FNMA 30yr mortg	8.25	0.7%	6.3%	Gold, cash - H&H	380.45	0.1%	-0.7%
NASDAQ	1227	3.5%	17.6%	Prime Rate	8.25	0.0%	-5.7%	W Tx Int Cr Oil	24.40	17.1%	39.3%
Wilshire 5000	6766	2.3%	16.5%	Fed Funds Trgt	5.25	0.0%	-8.7%	CRB Futures Ind	245.68	-1.2%	1.6%
Russell 2000	346	-0.1%	11.6%	Fed Disc Rate	5.00	0.0%	-4.8%	CRB Raw Indust	339.01	2.0%	1.7%

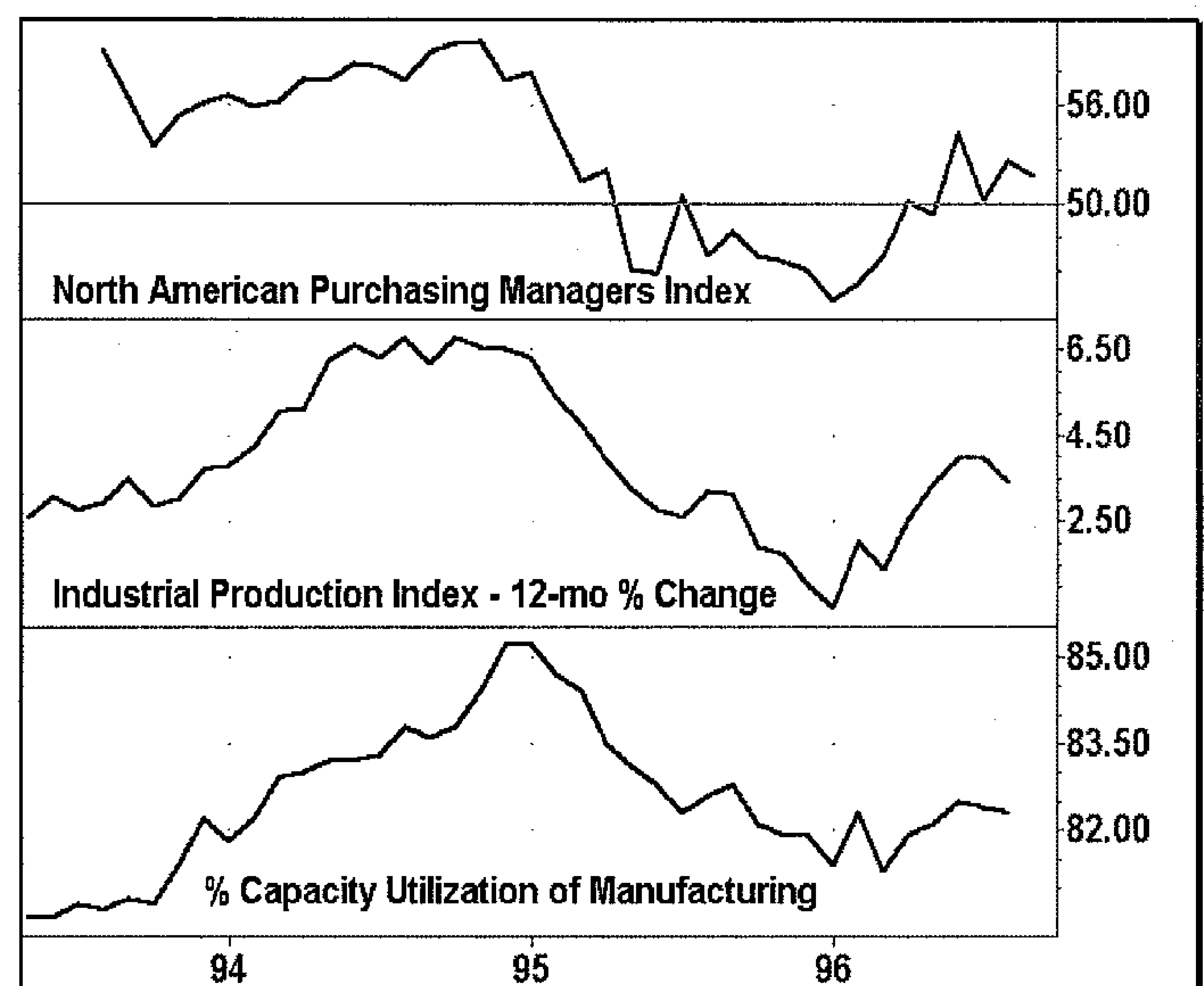
* excluding dividends

Money				Industry				Economy			
M2, Bil Curr$, Aug	3755	0.6%	0.3%	Ind Prod Ind, Aug	126.9	1.2%	3.4%	GDP, 2nd Qtr	6894.50	4.7% apr	2.7%
Free Reserves	769	190	79	NAPM Ind, Aug	54.3	3.3	5.7	Unempl, Aug - %	5.1	-0.1	-0.4
Money Mkts - Bil$	847	3.9%	15.6%	Cap Util, Aug - %	83.5	0.2	-0.4	Leading Ind, Aug	103.3	0.9%	2.1%

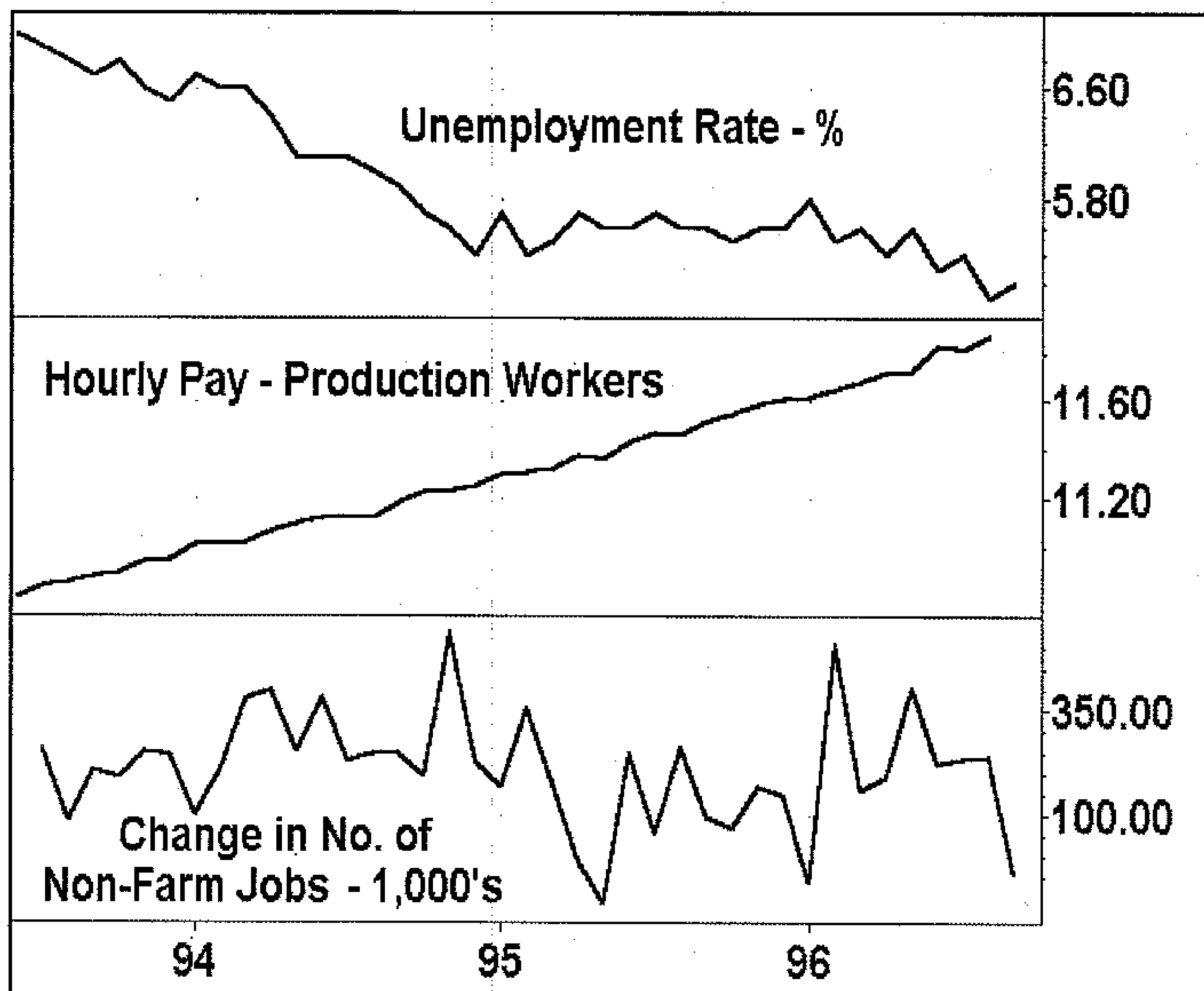
The figures above show how interest rates have stabilized over the past three months. Over the past 12 months, however, long rates have risen while short rates have fallen, steepening the yield curve. The second quarter GDP growth of 4.7% (annual rate) was far above the Fed's target of 2 to 2-1/2%. Because of that and a very low unemployment rate, many people had anticipated the Fed to raise interest rates at the Open Market Committee meeting on September 24th. That meeting came and went without any change in rates. The T-bill rate immediately dropped by ¼ point, as the built-in bias for the rate hike was taken out. The Fed and many economists have been anticipating a slowdown in the rate of economic growth because of several factors: higher long interest rates, a high level of consumer debt that restrains spending and a strong dollar that cuts down on exports. It was this expectation along with the lack of any concrete evidence of inflation that presumably influenced the Fed to leave interest rates unchanged.

The money supply has hardly grown in either 3 or 12 months, and free reserves in the banking system are at a lower level than either 3 or 12 months ago. Taken together, these figures mean that the Fed has kept a pretty tight grip on the money supply and has not encouraged the growth of credit.

MANUFACTURING The manufacturing sector of our economy appears to have leveled out somewhat after a spurt of growth in the first half of the year. The NAPM Index has climbed above the 50-line, which divides contraction from expansion. September's figure of 51.7 indicates a slow rate of growth. The Industrial Production Index and Capacity Utilization of Manufacturing both show a similar patter: a sharp increase early in the year which seems to have slowed and rolled over into a decline. Likewise, factory orders declined by 1.9% in August after a decrease of 1.7% in July. August durable goods orders were down 3.1% from July, which had seen a big increase over June. One area showing strength is construction and housing. Construction spending was up 0.9% in August after a decline in July. Housing starts hit 1,525,000 in August, the highest monthly rate since March of 1994. Existing home sales were off slightly in August, but from a very high level, and appear to be headed for a record year. All this activity in homes and construction reflects a high level of job growth, income and security. All these warm feelings are confirmed by the Index of Consumer Confidence, which rose to 109.4, the highest level since 1990. The activity in housing was a surprise in that interest rates have not been falling rapidly and consumer debt has reached very high levels that would usually tend to restrain spending.

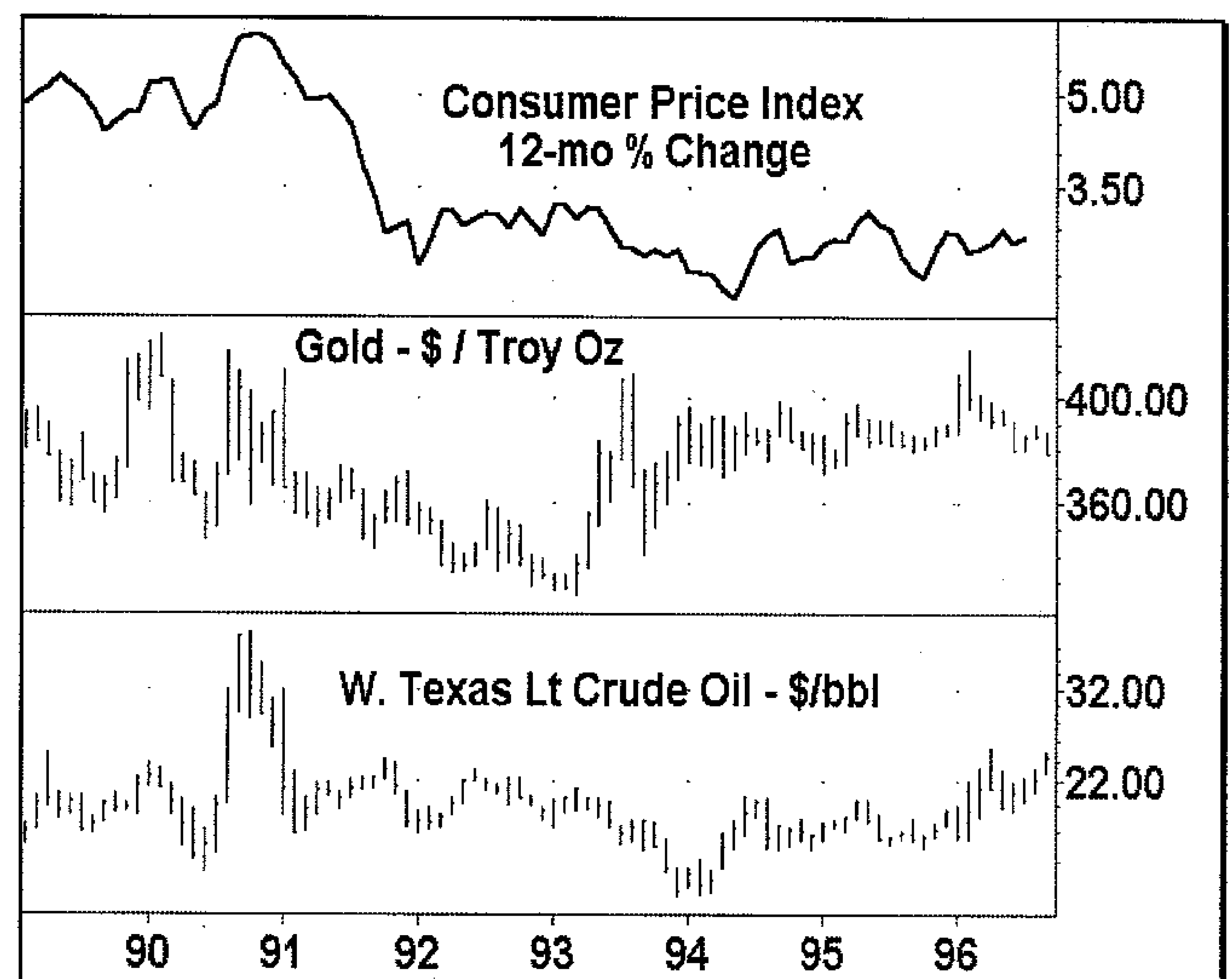


LABOR The labor market has been the primary source of recent worries about increased inflation. The unemployment rate has been under 6% since August of 1994, and reached a low of 5.1% in August. In September it slipped back to 5.2%. While this wasn't exactly an earthshaking change, it did fall in line with the widespread expectations of a slowing economy. The other figure that offers



evidence of a looser job market was the number of new non-farm jobs, which decreased by 40,000. The number of new jobs has been the particular number that has driven the bond and stock markets sharply up or down this year. September's figures were no exception: this was the first actual decrease in the number of new jobs since the blizzard conditions last January, and both the bond and stock markets soared on the news. The number expected had been an increase of about 165,000. Other news that came out at the same time was not so encouraging for the inflation outlook: hourly pay for production workers climbed by 6 cents/hour, or 0.5% for the month of September. While this is only a 3.5% increase on a yearly basis, the rate has picked up steadily since May of this year. A recent article in *The Wall Street Journal* cited an instance of a trucking company raising drivers' pay by a company-wide average of 33% because they simply couldn't find people who were willing and able to do the work required at the wages they had been offering. It is this kind of shortage that has many worried about possible wage inflation.

INFLATION Most of the measures of price inflation shown at the top of the first page are virtually flat over 3 and 12 months. They include the Consumer Price Index (retail level), the Producer Price Index (wholesale level), Gold, the CRB Futures Index and the CRB Raw Industrials sub-index. Taken together, these create an unassailable case for a very low level of inflation in our economy at present. Only oil prices show a rapid increase: 17.1% over 3 months and 39.3% over 12 months. This increase is due to increased demand around the world and also to recent instability in the middle east-Persian Gulf area. Unfortunately, oil prices have a very broad effect on our economy while at the same time being more subject to influences from outside our borders: part of the increase in oil prices has nothing to do with our economy or increased demand. Nevertheless, oil prices are a major factor when looking at future levels of inflation. They affect everything from gasoline and heating oil to feedstocks for plastics. Heating oil is the most recent focus of attention because supplies are short and prices are climbing. It has increased from 51 cents/gal in June to 72 at the end of September. Oil companies have decided to reduce inventories of all materials they handle in order to reduce the holding cost. After sending some supplies of heating oil overseas, the result of this policy is roughly a 40% price increase in a short period. If we have a cold winter, this will drive up consumers' heating costs even further. This will have 2 particular effects on our economy. The first will be an uptick in inflation as the higher costs register in the CPI. The second will be to slow the overall economy because consumers will have less money to spend for non-essentials after their heating bills are paid.



CREDIT Consumer installment credit outstanding, which was growing at the torrid rate of over 15% last year has gradually slowed to around 11% by June of this year, the last numbers available. These numbers are adjusted for inflation. The ratio of consumer installment credit to personal income hit an all-time high in April of this year has backed off slightly, a sign that either consumers are less willing to buy or that they have borrowed all they can. This high level of consumer debt has been one of the factors expected to slow the economy. Considering the slowing growth of debt, it's possible that this process has begun.

SUMMARY The large number of new jobs and payrolls that hit the economy starting in February of this year caused a big jump in the economy in May and June. The high level of consumer debt continued to grow and add to the expansion of the economy until about May. Lower long interest rates also had a positive effect on economic growth, but rates rose in March and April. All of these things were partly responsible for the rapid growth in GDP for the second quarter. The bulge in growth in the second quarter seems to have been just that rather than an extended period of expansion. It takes about 6 or 8 months for the effects of higher interest rates to work their way into the economy and have a discernible effect; we are now about 6 months past the rate spike that began last March. The job growth that started in February seems to have reversed and, if it continues, will have a further dampening effect on the economy. Consumer credit remains very high placing a constraint on consumer spending. The strong dollar makes exports less competitive on the world market. All of these things will act to slow the economy in the coming months. The question is whether wage pressures and higher oil prices will counteract those factors enough to force the Fed to raise interest rates.