THE COMPASS

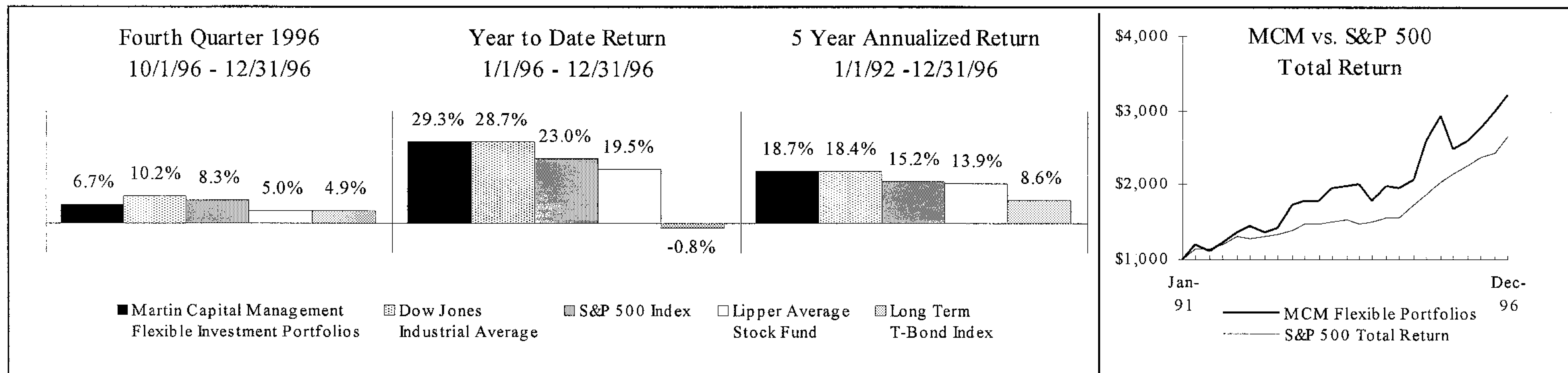
A QUARTERLY NEWSLETTER FROM MARTIN CAPITAL MANAGEMENT

100 Congress Avenue, Suite 2100 / AUSTIN, TEXAS / 78701 / Tel. 512-469-3772

January 1, 1997

DJIA 6448.27 / S&P 500 740.74 / NASDAQ Comp. 1291.03 / Wilshire 5000 7198.29 / Long T-bond Index 6.71% (6654.02)
3 month T-Bill rate 5.24% / Federal Funds Rate 5.25% / Discount Rate 5.00% / Prime Rate 8.25% / Inflation (CPI) 3.3%
Federal Reserve Dollar Index 88.12/ Oil $25.93 / Gold $368.30 / GDP (3Q) 2.1%

Investment Results



Investment Perspective

The fourth quarter brought home another banner year for the stock market. Average gains for the quarter in the major indexes ranged between 5% and 10%. For the year, the returns were between 15% and 30%. The bond market did not fair as well. Though bonds were up about 5% for the quarter, they were down almost 1% for the year. Our average flexible investment portfolio finished with a 6.7% return for the quarter and a 29.3% return for the year.

When the final statistics came in, economic growth proved to have faltered in the third quarter, as expected. This confirmed our belief that the Federal Reserve would not raise interest rates, contrary to the expectations of most economists. Despite the probable report of a pickup in economic growth when fourth quarter results are announced at the end of January, we still believe the Fed's next move will be to lower rates sometime during the first half of 1997. Interest rates will drop as it becomes clear that the economy in the first part of the year is still on track for suboptimal growth. The stock market may see a 10% correction toward the end of the first quarter, or the beginning of the second quarter, as profit projections are lowered for the slowing economy. Once the Fed finally moves to ease interest rates, the stock market will rebound in anticipation of improving economic activity and corporate profits by the end of the year. We expect the stock market to perform well in the first half of the quarter, but perhaps to fall back during the last half of the quarter, resulting in a flat to slightly positive performance by the end of the quarter. Bonds may have a contrary performance pattern to stocks for the quarter, and could finish with a strong enough rally to outperform stocks. For now, we are maintaining our current asset allocation as indicated in the chart below.

It's ironic, given the outstanding long-term performance of the stock market, that the bulls cannot get at least some respect from the bears. As the greatest bull market of the century stampedes relentlessly forward, pausing only occasionally to catch its breath, the bears defiantly growl that it's foolish to participate in a stock market with such high valuations. They condescendingly explain that dividend yields are too low, and price to earnings and price to book ratios are too high; however, putting the facts in perspective, high valuations have historically been sustained for long periods during times of low to moderate inflation. In contempt, disguised as concern, the bears cry that a tremendous number of new and unbelievably naïve investors will panic and lose everything when the bull market inevitably stumbles; however, putting the facts in perspective, the average new investor is not speculating, but investing for retirement. Ever searching for simplistic historical patterns to justify their fears, the bears knowingly pontificate that the stock market cannot go up forever; however, putting the facts in perspective, the stock market on a long-term basis does go up forever - compounding at better than 10% since 1926 (the first year for which accurate S&P 500 performance data is available). But the bears aren't interested in putting facts in perspective. They want only simple answers to justify their fears. The real irony is that though the bulls will ultimately succeed in their goal of increasing investment capital, they will falter occasionally along the way, but the bears will always succeed in their goal of merely maintaining investment capital. One wonders if the bears' satisfaction in preserving assets during periodic bear markets adequately compensates them for the poor long-term performance of their investment portfolios.

Recommended Flexible Asset Allocation

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

Market Timing Viewpoint

	Three Month Performance Expectation March 31, 1997					
	Optimistic		Most Likely		Pessimistic	
	Target	%Change	Target	%Change	Target	%Change
DJIA/S&P 500	7150/810	+10.0%	6800/775	+05.0%	6200/670	-05.0%
Nasdaq	1430	+10.0%	1365	+05.0%	1230	-05.0%
T-Bond Index	5.9%	+15.0%	6.3%	+10.0%	6.70%	+00.0%

20 Largest Common Stock Positions
(Prices as of December 31, 1996)

1	Dell Computer	53.13	6	Microsoft	82.63	11	Williams-Sonoma	36.38	16	Oracle	41.75
2	Intel	130.94	7	Applied Materials	35.94	12	Motorola	61.25	17	Southwest Airlines	22.00
3	Schwab (Chas)	32.00	8	Texas Instruments	63.75	13	Chrysler	33.00	18	CompUSA	20.75
4	Cisco Systems	63.63	9	Electronic Arts	29.94	14	U.S. Robotics	72.00	19	Home Depot	50.13
5	Hewlett-Packard	50.25	10	Whole Foods Mkt.	22.50	15	Advanced Micro Dev.	25.75	20	Cirrus Logic	15.50

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
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%	+ 17.3%	+ 2.7%	+ 2.7%
1994	- 2.0%	+ 5.9%	+ 1.3%	- 0.1%	- 6.9%	+ 3.8%	+ 2.7%
1995	+ 27.5%	+ 36.9%	+ 37.4%	+ 36.5%	+ 30.7%	+ 5.5%	+ 2.6%
1996	+ 29.3%	+ 28.7%	+ 23.0%	+ 21.2%	+ 8.9%	+ 5.0%	+ 3.3%
Total**	+220.2%	+196.0%	+164.8%	+169.0%	+ 79.2%	+ 28.2%	+ 18.7%
Avg.***	+ 21.4%	+ 19.8%	+ 17.6%	+ 17.9%	+ 10.2%	+ 4.2%	+ 2.9%

* 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.

*** 6 year annualized return (1991 - 1996).

(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 December 31, 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	6448	9.6%	26.0%	91-day T-Bill DR	5.12	3.1%	2.2%	CPI, Nov	158.70	3.3% apr	3.2%
S&P500	741	7.8%	20.3%	30-yr T-Bond Yld	6.65	-3.9%	11.8%	PPI, Nov	132.70	4.0% apr	3.1%
NYSE Comp Ind	392	6.8%	19.1%	FNMA 30yr mortg	7.74	-6.2%	8.3%	Gold, cash - H&H	369.00	-3.0%	-4.6%
NASDAQ	1291	5.2%	22.7%	Prime Rate	8.25	0.0%	-2.9%	W Tx Int Cr Oil	25.93	6.3%	33.2%
Wilshire 5000	7198	6.4%	18.8%	Fed Funds Trgt	5.25	0.0%	-4.5%	CRB Futures Ind	239.61	-2.5%	-1.5%
Russell 2000	363	4.7%	14.8%	Fed Disc Rate	5.00	0.0%	-4.8%	CRB Raw Indust	334.92	-1.2%	0.8%

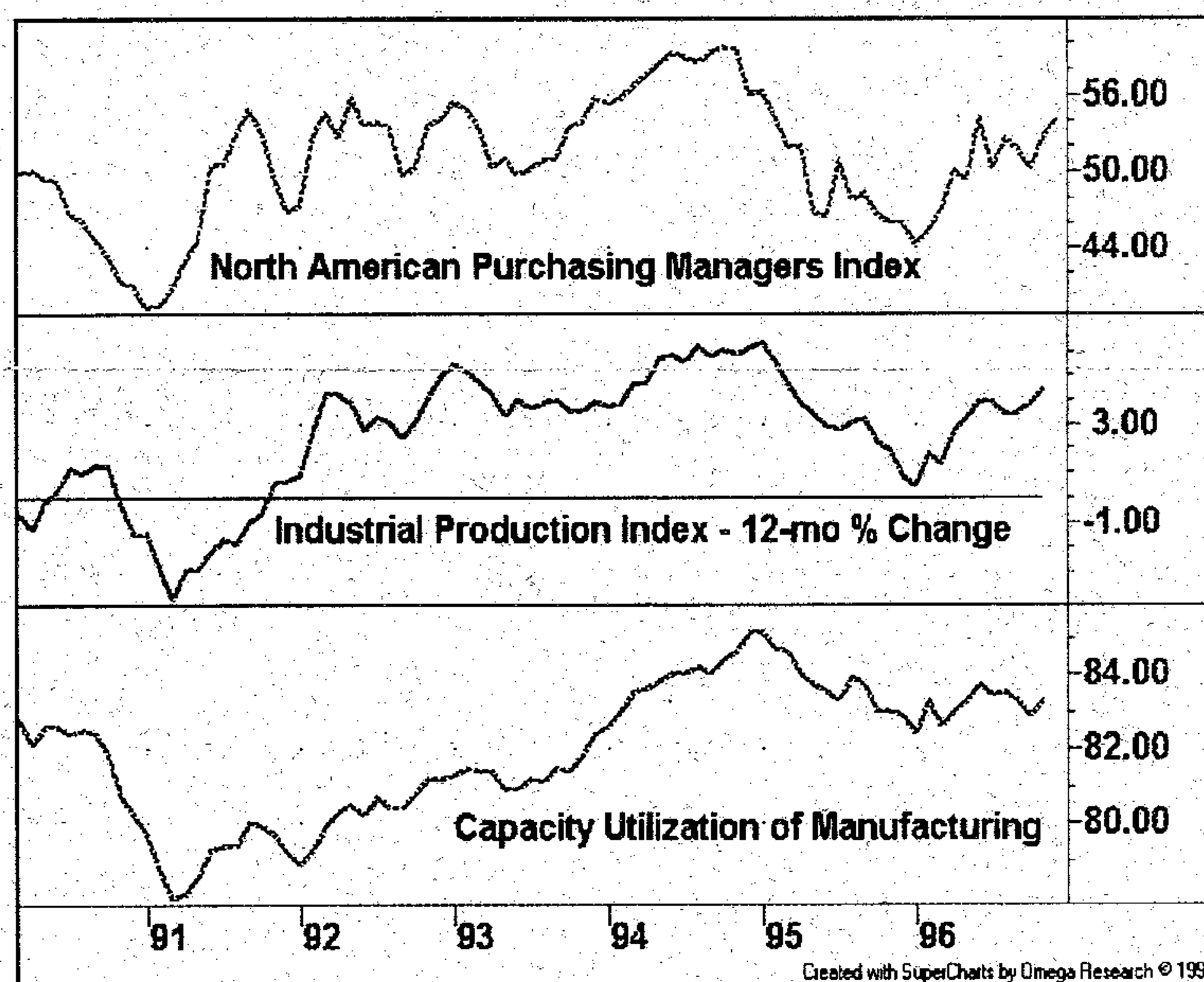
* excluding dividends

Money				Industry				Economy			
M2, Bil Curr$, Nov	3796	1.1%	4.3%	Ind Prod Ind, Nov	128.0	0.9%	4.4%	GDP, 3rd Qtr	6928.4	2.1% apr	3.2%
Free Reserves	1335	761	525	NAPM Ind, Dec	54.0	2.3	8.0	Unempl, Nov - %	5.4	0.3	-0.2
Money Mkts - Bil$	913	3.9%	15.6%	Cap Util, Nov - %	83.3	-0.2	0.3	Leading Ind, Nov	102.6	0.2%	1.7%

Short interest rates have remained relatively stable over the past quarter and the past year, while long rates have moved up and down through the year. The table above unfortunately leaves out a big part of the story because long rates rose more than 1-1/4% between December 1995 and the high points reached in June and July of 1996. We see illustrated in the percentage changes above part of the results of the low point in long rates last December and the decline after mid-year. Short interest rates have varied by less than half a point over the year, not following the volatile path of long rates, and virtually their whole story is evident in the figures.

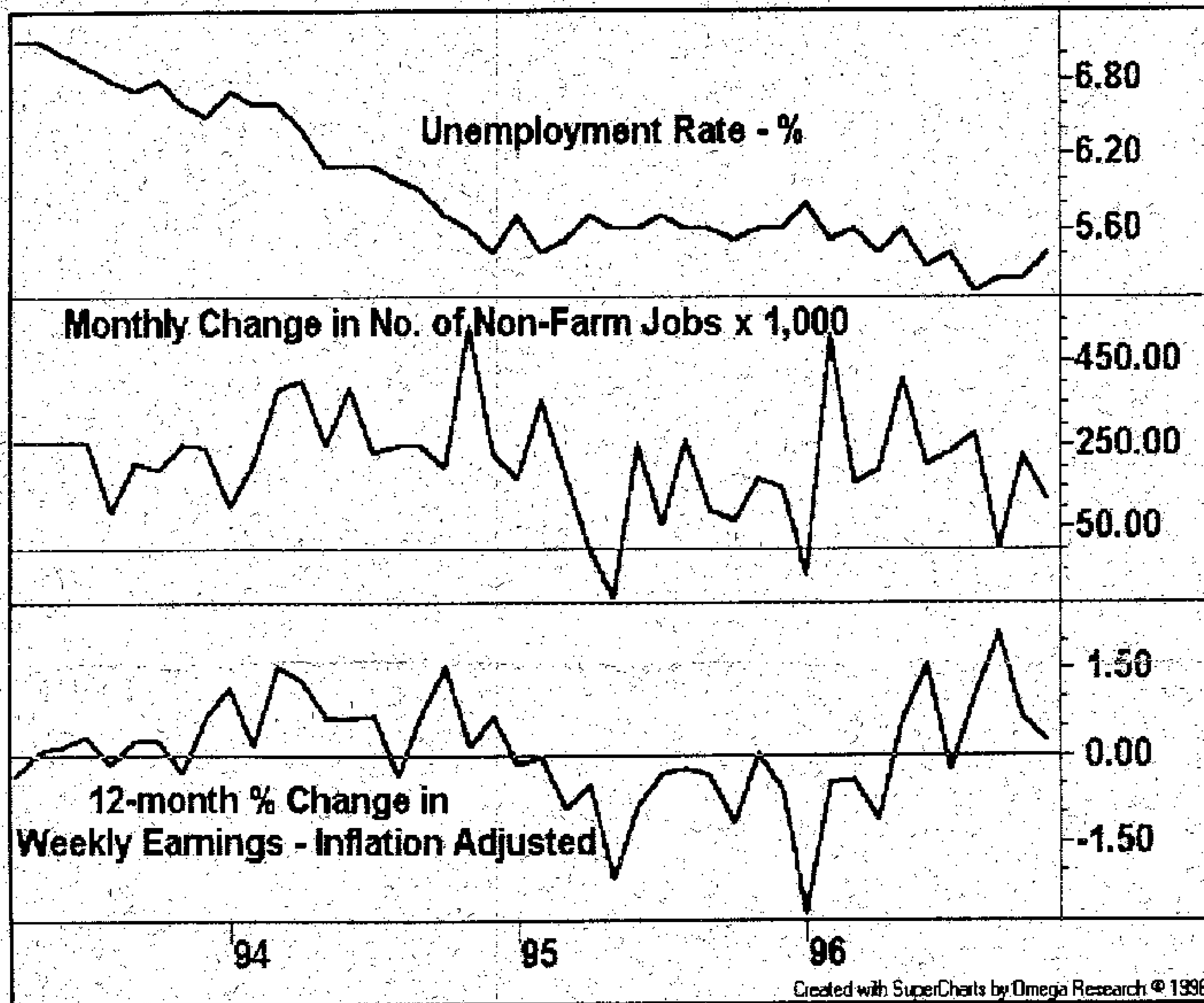
Second quarter GDP growth reached a hot 4.7%, creating fears of rate increases by the Fed to slow down the economy. Rate increases did not take place, and it was fortunate that they did not because growth slowed in the 3rd quarter to an annual rate of 2.1% without that restraint. Part of this slowing was probably a result of higher long interest rates, which helped achieve the desire of the Fed without a short rate increase. Had there been a rate increase, we would have seen an economy slowing considerably more.

MANUFACTURING Figures recently released on the manufacturing sector point to at least a slight acceleration of growth. The North American Purchasing Managers Index rose to 54 in December, indicating a slow to moderate rate of growth. While this the highest level since a peak last June and is higher than it has been for most of this year, it is still not high by historical standards. It is also not far above 50, which marks the separation of expansion from contraction in the manufacturing sector. Another area causing concern about possibly too-rapid growth was housing: new home sales shot up 14.2% in November, a time of year usually regarded as slow for that industry. All regions of the country showed a respectable increase, but the northeast registered a stunning 40.3% increase over the previous month. Putting this in perspective, October showed a decrease of 13.3% over the month before, so putting the 2 months together almost makes it a wash. It remains to be seen whether this growth will continue. An important factor may have been the strong downward trend in mortgage rates, which reached a recent bottom in the month of November, after which they rose sharply. The higher rates in December will have a tendency to slow the growth in home sales. The rates of contracting for new construction, including commercial, public and private, have been fairly weak for the entire year. The peak in dollar volume of contracting for private housing was reached in April, and it has fallen 12% from that high through November, which showed a slight decrease of 3% for the month.

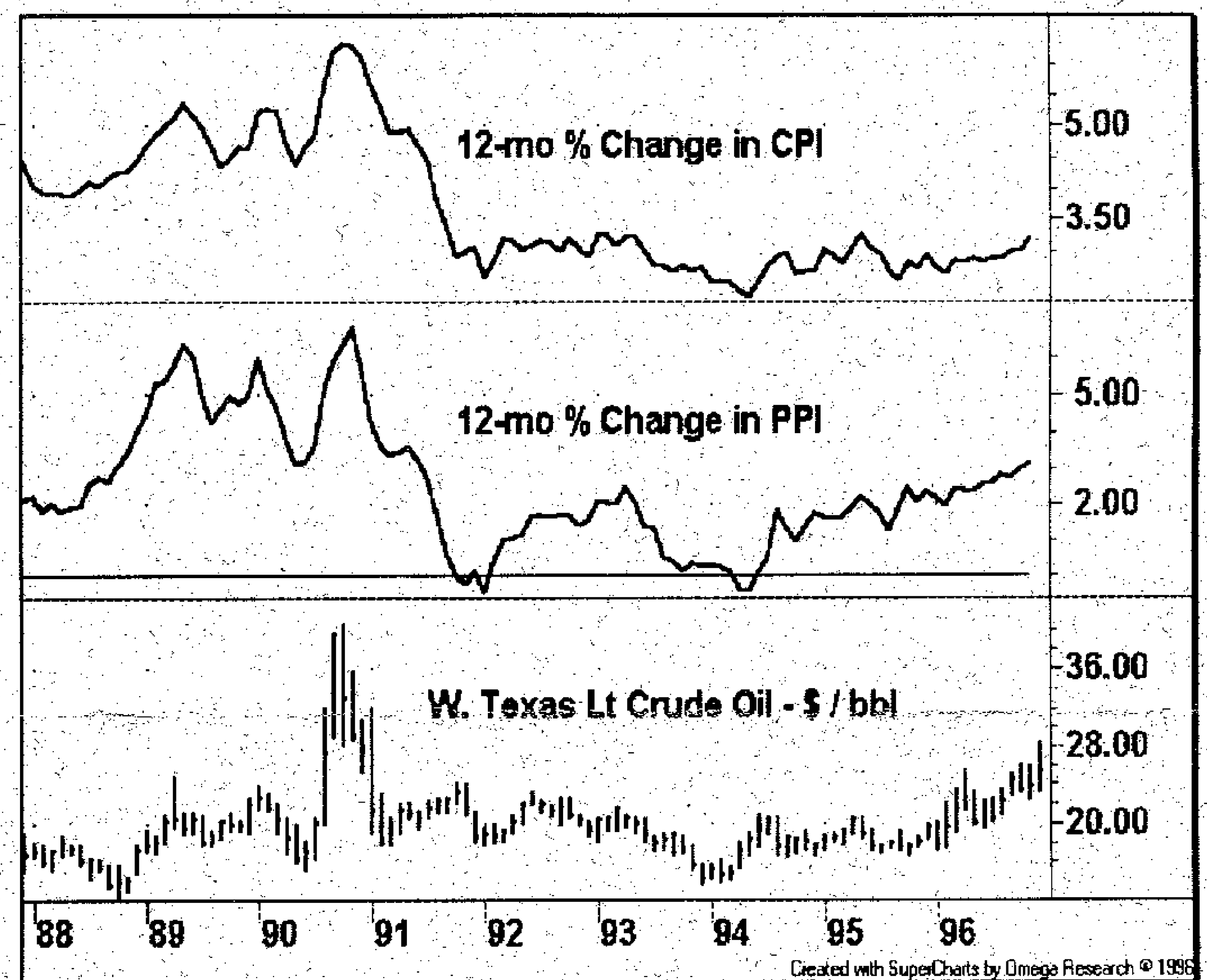


The Industrial Production Index showed a higher 12-month increase of 4.4% in November. The middle chart above shows the rapid increase during the first part of 1996, after which it seems to have leveled off a bit. Its present rate of increase puts it roughly in the middle of the range it occupied from 1992 through 1995. Capacity utilization of manufacturing shows a very slight uptrend for 1996, not yet steep enough or high enough to cause serious concerns about shortages of capacity and resulting price increases.

LABOR The labor market was the focal point for fears of inflation for most of 1996. The unemployment rate dropped unevenly throughout the year until it bottomed at 5.1% in August, then rebounded up to 5.4% in November. The huge increase in the number of non-farm jobs in February 1996, 510,000, (spike in the middle chart at right) tapered off in a general downward trend for the rest of the year. An unemployment rate of 5.1% is historically very low and down in the range that has traditionally been regarded as producing a labor market tight enough to ignite wage pressures. As a general rule, 2/3 of inflation has been regarded as coming from labor, so these fears were justified to some extent. Nevertheless, we have not yet seen any significant wage pressures evident so far. The bottom chart at left shows average weekly earnings of production workers, adjusted for inflation. The latest real rate of increase of weekly earnings was 0.25%, hardly a figure for even the most timid inflation hawks to lose sleep over. Overall, these numbers conform to the upturn in the economy during the first half that has since slowed down. The general decrease in the growth of jobs is also encouraging in this respect as it points to the labor market becoming less tight. A slowing of new jobs means fewer payroll dollars being spent, less demand for goods and services and lower production levels because of the reduced demand. Without a sudden upturn in jobs such as happened early last year, these factors lead to a continued steady economy without overly strong growth.



INFLATION The Consumer Price Index of prices at the retail level shows an increase of 3.2% over the past 12 months, a rate near the upper end of the range it has stayed in since mid-1991. This measurement is generally regarded as the overall rate of inflation in our economy. By historical standards, the past five years have been one of the most stable periods of steady low inflation in history. There is little evidence indicating that we might soon see any serious deviation from these stable conditions. The price of oil seems to be the only thing that could cause even a mild impact. Oil has risen from less than $17/barrel in October 1995 to over $25/barrel at present, an increase of about 50%. This has already had an effect on the Producer Price Index of wholesale prices and will have more of an effect on the CPI in the future. A general correlation exists on the chart at right between rises in oil prices and rises in the CPI and PPI. The inflationary effects lag the oil price rises slightly, as it takes time for the higher prices to work their way through the system. We will be fortunate if we escape a mild pulse of inflation associated with the latest rise in oil prices. However, the good news here is that the price of oil has probably peaked and will drop back somewhat from its present highs. This means that whatever inflation is generated by higher oil prices will only be a pulse and not be sustained for any extended period.



Other commodity prices show very few signs of price inflation. Aluminum and copper prices both declined about 40% to a mid-1996 low that they are just beginning to climb out of. Zinc prices are still more than 30% below the 1995 high, headed down. Scrap steel is now in a steep decline, 20% lower than a year ago. Gold hit a 3-year low during the past week. This price information does not paint a picture of a surging economy with incipient inflation. Oil and other energy prices seem to be unique in their strength.

SUMMARY Our economy appears to be growing moderately with occasional spurts of exceptional growth like the 2nd quarter of 1996. The manufacturing sector is operating at what seems to be an optimum level, neither too fast that would strain capacity and create bottlenecks, nor too slow that would hurt efficiency and lead to elimination of large numbers of jobs. We have been at or very near what is regarded as "full employment" for many months without any significant signs of wage inflation beginning to permeate the economy. Commodity prices with the important exception of oil remain generally soft. This is an economy on a very even keel.