THE COMPASS

A QUARTERLY NEWSLETTER FROM MARTIN CAPITAL MANAGEMENT

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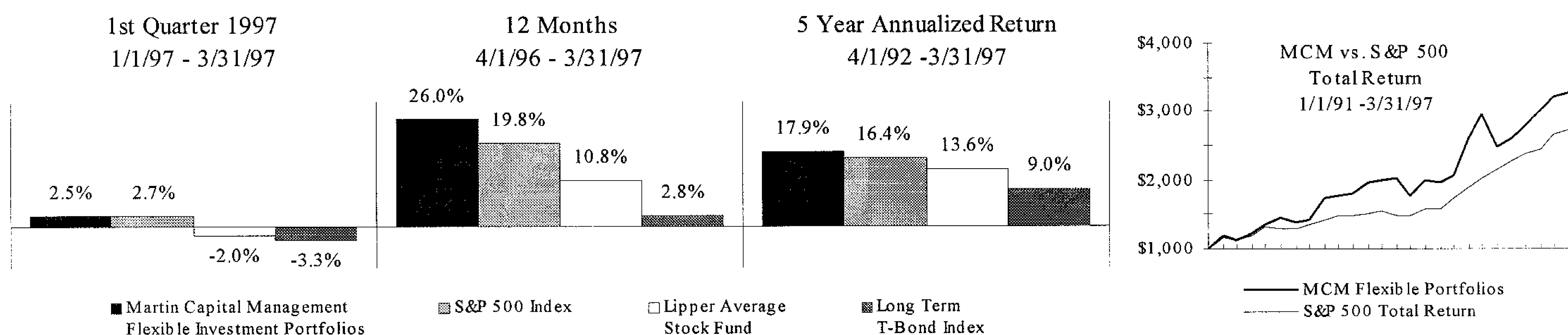
April 1, 1997

DJIA 6583.48 / S&P 500 757.12 / NASDAQ Comp. 1221.70 / Wilshire 5000 7213.53 / Long T-bond Index 7.21% (6436.98)
3 month T-Bill rate 5.20% / Federal Funds Rate 5.50% / Discount Rate 5.00% / Prime Rate 8.50% / Inflation (CPI) 3.0%
Federal Reserve Dollar Index 94.72/ Oil $20.43 / Gold $351.00 / GDP (4Q) 3.8%

Investment Results



Investment Perspective

First quarter results for the stock market were in line with our expectation of a strong first half and weak second half, ending with a slightly positive finish for the S&P 500. A large portion of the market experienced negative results, however, resulting in a slight loss for the average stock mutual fund. The bond market did not fair as well as we had hoped. Despite relatively high interest rates, the economy cruised ahead with strong growth during the first quarter, spooking the bond market vigilantes to push rates over 7%, well above our pessimistic target of a maximum rate of 6.7% at the end of the quarter.

GDP growth for the last quarter of 1996 came in at 3.8%, in line with our 4% growth forecast. When the first quarter numbers are posted, they will probably prove to be stronger than predicted several months ago. Despite the tremendous resiliency of the U.S. economy, we believe that current interest rates are high enough to slow the economy by the end of the second quarter. Admittedly, the tightening move by the Federal Reserve Board at the end of the first quarter was not projected in the newsletter at the beginning of the year, but in the final analysis there may be some doubt as to whether the move was the right thing to do. At this point, the economy is not in danger of recession in the near future, but any further interest rate hikes will substantially increase the odds for sub-optimal growth in the last half of the year. For the time being we are maintaining the previous asset allocation of 90% stocks and 10% bonds for flexible portfolios, but will consider defensive measures if interest rates go much higher than current levels.

Barring any unforeseeable disruptions in the global economy, we continue to think that a 15% to 20% return for the year is achievable. The main question for now is how preemptively aggressive the bond market and the Fed will be in fighting non-existent inflation. If Fed Funds go over 5.75%, or Treasury Bonds go over 7.5%, then we would become concerned about the short-term prospects for the stock market. The risk of a severe bear market is minimal, but, depending on whether interest rates are driven much higher, there could be a substantial correction by the middle of the year. For the time being we are staying with the notion that inflation will remain under control, and that interest rates will not be pushed so high as to torpedo the economy. Eventually, the bond market and the Federal Reserve Board will come around to the fact that the economy can expand at higher rates of growth with low inflation. Though it will take many years for this to occur, the gradual conversion to the acceptance of faster growth will provide fuel for the bull market well into the next century.

Recommended Flexible Asset Allocation

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

Market Timing Viewpoint

	Three Month Performance Expectation June 30, 1997					
	Optimistic		Most Likely		Pessimistic	
	Target	%Change	Target	%Change	Target	%Change
DJIA/S&P 500	7250/825	+10.0%	6900/795	+05.0%	5950/685	-10.0%
Nasdaq	1400	+15.0%	1280	+05.0%	1100	-10.0%
T-Bond Index	6.2%	+15.0%	6.5%	+10.0%	7.50%	-05.0%

20 Largest Common Stock Positions
(Prices as of March 31, 1997)

1	Dell Computer	67.63	6	Hewlett-Packard	53.38	11	Electronic Arts	26.63	16	Oracle	38.56
2	Intel	139.13	7	Advanced Micro Dev	41.50	12	Motorola	60.50	17	Chrysler	30.00
3	Charles Schwab	32.00	8	Texas Instruments	74.88	13	Williams-Sonoma	28.75	18	Home Depot	53.50
4	Applied Materials	46.38	9	Cisco Systems	48.13	14	Micron Technology	40.38	19	LSI Logic	34.75
5	Microsoft	91.69	10	Whole Foods Mkt	20.75	15	Southwest Airlines	22.13	20	Tiffany	38.00

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%	+ 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 March 31, 1997, 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	6583	2.1%	17.8%	91-day T-Bill DR	5.21	3.0%	4.2%	CPI, Feb	159.80	0.6% apr	3.0%
S&P500	757	2.2%	17.3%	30-yr T-Bond Yld	7.09	6.6%	6.1%	PPI, Feb	132.50	-0.1% apr	2.2%
NYSE Comp Ind	399	1.6%	14.9%	FNMA 30yr mortg	8.31	7.4%	5.1%	Gold, cash - H&H	349.10	-5.4%	-11.6%
NASDAQ	1222	-5.4%	10.9%	Prime Rate	8.50	3.0%	3.0%	W Tx Int Cr Oil	20.45	-21.1%	-5.5%
Wilshire 5000	7214	0.2%	13.3%	Fed Funds Trgt	5.50	4.8%	4.8%	CRB Futures Ind	245.15	2.3%	-2.5%
Russell 2000	343	-5.5%	3.6%	Fed Disc Rate	5.00	0.0%	0.0%	CRB Raw Indust	338.46	1.1%	2.2%

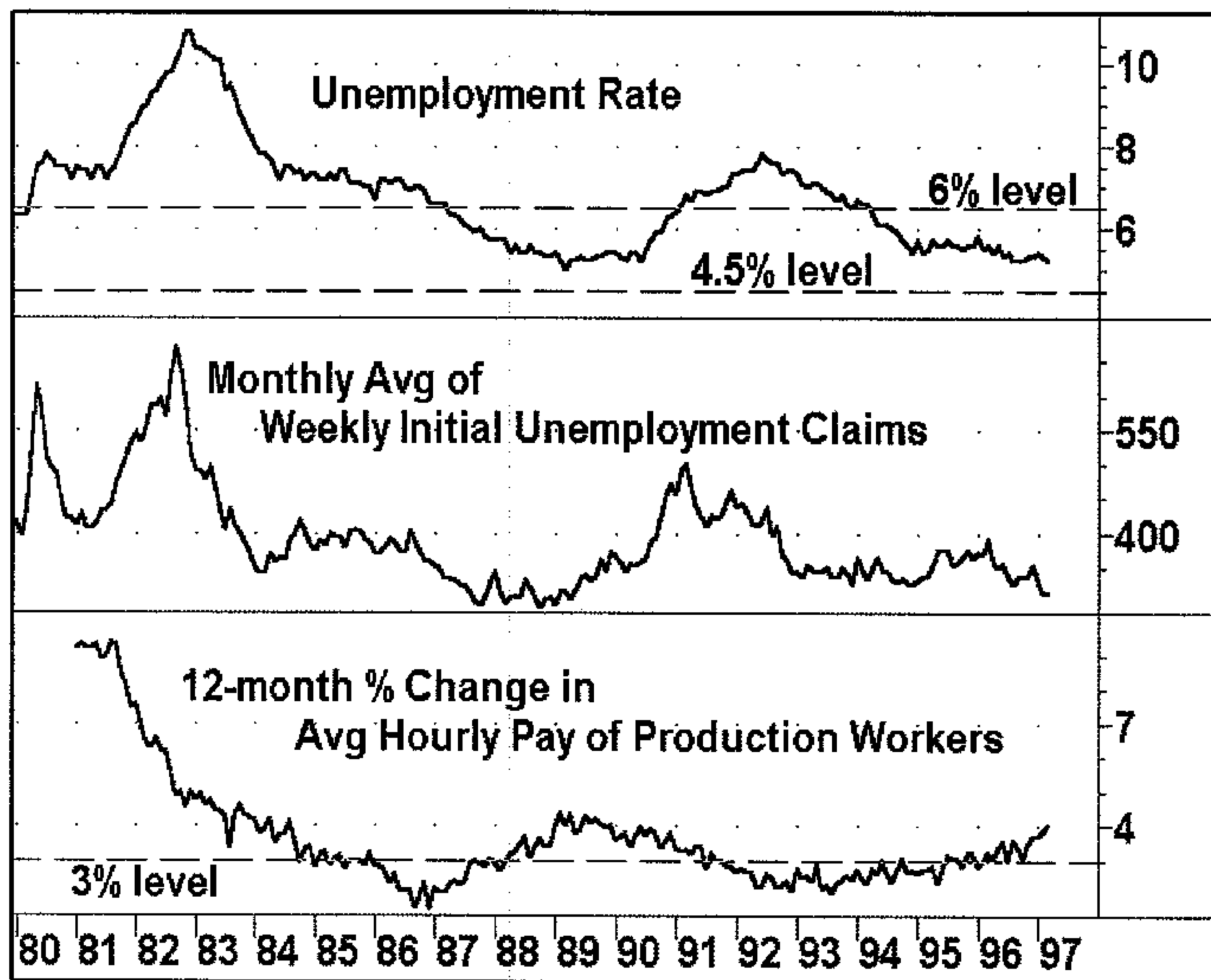
* excluding dividends

Money				Industry				Economy			
M2, Bil Curr$, Feb	3866	0.9%	4.7%	Ind Prod Ind, Feb	118.1	0.8%	3.8%	GDP, 4th Qtr	6994	3.8% apr	3.1%
Free Reserves	830	-505	-321	NAPM Ind, Mar	55.0	1.2	7.7	Unempl, Feb - %		0.0	-0.2
Money Mkts - Bil$	965	5.7%	18.5%	Cap Util, Feb - %	83.3	-0.1	0.1	Leading Ind, Feb	103.5	0.9%	2.1%

The table above shows how stocks have slowed their rate of growth over the past quarter compared to the past year, also how big cap stocks in the Dow Industrials and S&P500 have left the NASDAQ and small cap stocks in the Russell 2000 behind. With respect to interest rates, the first quarter of this year accounted for virtually all of the rate increases for the entire year. While this oversimplifies what happened with the more volatile long rates, it does put in perspective the relative size of the recent upward move in yields compared to the entire year. The commodity prices and indices clearly show the general lack of inflationary tendencies. There are no surprises in any of the remaining figures except perhaps the increase in the amount of money in money market funds. This figure has grown steadily over the past year.

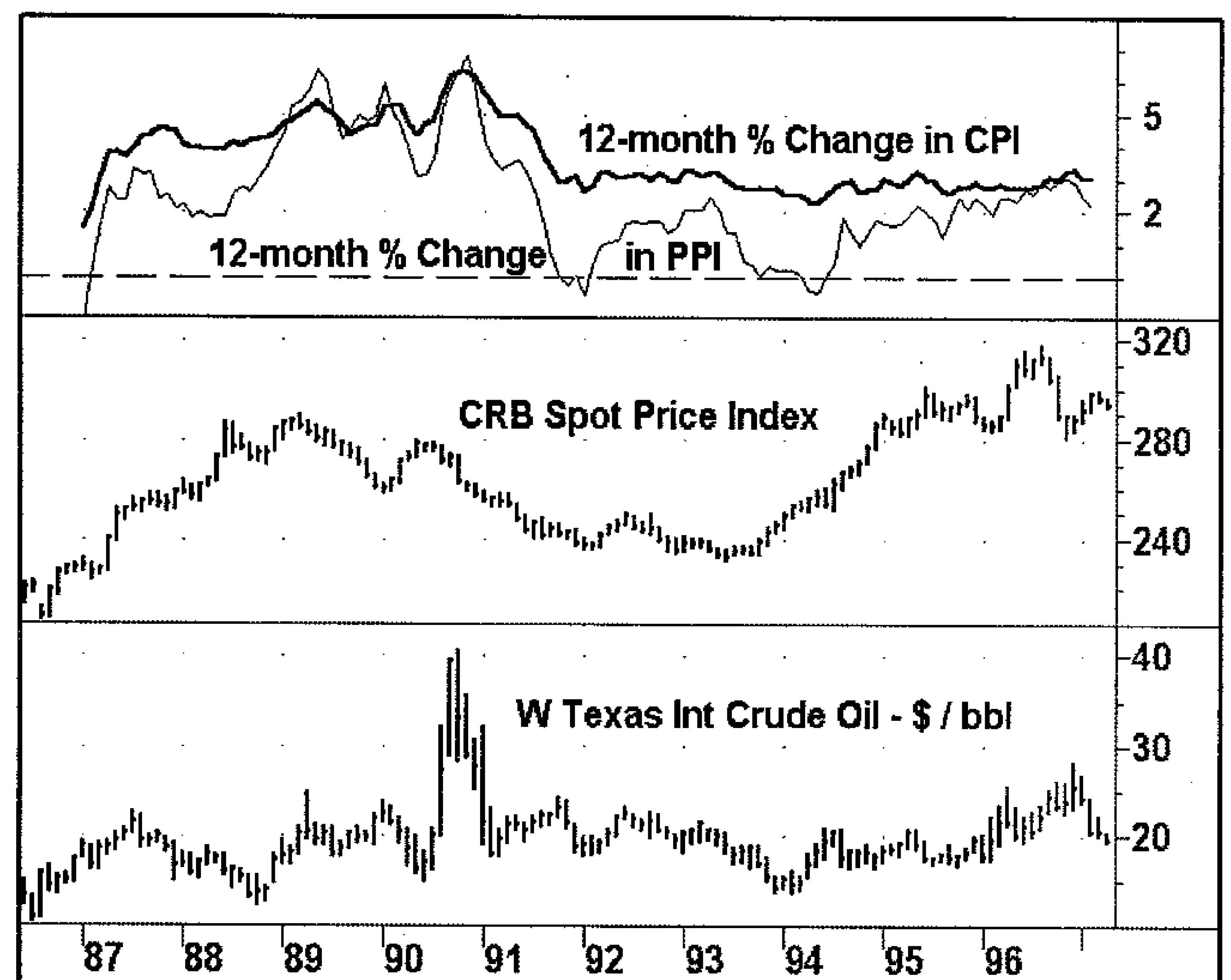
MANUFACTURING The manufacturing sector of our economy appears to be experiencing more rapid growth. Evidence for that growth is found in the North American Purchasing Managers Index, the top chart at right, which rose to 55.0 in March. This is the highest level in 2 years, but not close to historic highs well above 60. Similar in shape but not shown here is the 12-month change in the Industrial Production Index, which has the same recent upward trend. Capacity utilization of industry, the middle chart at right, is maintaining a relatively high level compared to the past 10 years, but is not turning up strongly. Industry is apparently managing to increase capacity enough to keep up with increased demand for plants and other facilities. The bottom chart shows the 12-month change in manufacturers' new orders for consumer goods. This chart shows a very rapid increase since early 1996. Consumer spending makes up 2/3 of our economy, so rapid growth in orders for consumer goods can imply similar growth in the economy as a whole. This chart also ties in closely with very strong retail sales during the first quarter of 1997. Construction spending rose by 2.3% in February, more than expected, and factory orders were up 0.8%. Another survey similar to the NAPM Index is the APICS, which rose from 47.8 to 51.1 in March. Virtually all indicators of the manufacturing or industrial sector of our economy show the same pattern as these in the charts above: moderate to strong growth. Virtually none show any weakening.

LABOR Statistics for the labor market in the first quarter show overall conditions strengthening. The unemployment rate dropped from 5.4% in January to 5.2% in March. The top chart on the next page shows conditions in the labor market for the past 17 years. Many believe that the non-accelerating rate of unemployment (NAIRU) lies at 6%, meaning that an unemployment rate lower than 6% for an extended period will bring on inflation. In the 1950's and early 1960's, it was clear that the NAIRU was down around 4.5% (see the top chart on the next page). Conditions have changed a great deal since the 1960's, with many more women in the workforce and a worldwide rather than just a national labor market. Factories in the U.S. are constantly being closed and production moved overseas to take advantage of lower labor costs. The effect of these factors and others on the true level of the NAIRU is uncertain and widely debated.



The number of weekly initial unemployment claims is essentially a measure of how many people are losing their jobs every week. A low average number over a month implies a firm labor market with greater job security. This average has dropped substantially over the past 15 months to the lowest level since 1989, and is approaching the lowest in 20 years (middle chart at left). The 12-month change in hourly pay of production workers rose to 4.02% in March (bottom chart at left). We have good news and bad news here: the good news is that this is only a percentage point above the overall inflation rate, while the bad news is that this is the fastest rate of increase since 1989. From any point of view, however, it represents a higher rate of pay increases, which in turn points to a tighter labor market. The uptrend in the rate of wage increases started in 1993 from a level of 2%, which was not even keeping up with inflation. The average number of hours worked per week by workers in manufacturing was the highest in 2 years, as was the average number of overtime hours worked each week. One statistic ran counter to the trend toward a stronger labor market: the number on new non-farm jobs grew by only 175,000, the smallest number in 6 months.

INFLATION The present rate of inflation in our economy, as measured by the 12-month change in the Consumer Price Index, is 3% (top chart at right). Inflation at the wholesale level, as indicated by the Producer Price Index, is closer to annual rate of 2%. The CRB Spot Price Index (middle chart) contains a representative cross section of agricultural and industrial raw materials, so that it presents an accurate picture of the broad world of commodity prices. The chart shows that while the run-up in prices from 1993 to the middle of 1996 was a little scary, the upward trend has obviously been broken. The CRB Futures Index, a separate, agriculturally weighted commodity price index, has been in a downtrend since early 1996. The price of crude oil, a major source of worry about inflation last year, has dropped down below $20/bbl. (bottom chart). While not good for the state of Texas or individuals who make their living in the oil patch, this drop in the price of oil is very good news for prospects of inflation. No other commodity price has such a far-reaching effect on our economy and on prices of other products and services. The price of gold languishes at around $350/oz., near a 3-year low. Gold bugs should be embarrassed at last year's predictions of $450/oz. and higher.



The only area showing any minimal tendency or trend toward inflation is the higher rate of increase in hourly wages mentioned above. At a rate of increase of only 4%, hourly wages are not exactly in a stampede toward rampant inflation. Nevertheless, this has been one of the greatest sources of worry to the Fed as, historically, 2/3 of inflation has been said to result from wage increases.

SUMMARY The manufacturing sector of our economy seems to be expanding at a pretty rapid clip. Retail sales and demand for consumer products are also strong, adding another indication of strong economic growth. The first quarter of 1997 may see GDP growth rise by as much as 4% as a result. We have managed to achieve this rate of growth so far without igniting the fires of inflation. The chart at left shows quarter-to-quarter growth of GDP at an annual rate over the past 20 years. After the wild excesses of the 1970's and early 1980's, inflation and economic growth stabilized. Since 1985, changes have been largely contained between 0% and 6% except for the recession of 1990. During the ultra-stable period of low inflation since 1991, changes in GDP have been held to between 0% and 5%, and our present rate of economic growth is not at all out of line with the recent past. Nevertheless, the Fed has a target rate for growth of 2.0% to 2.5%, and obviously fears that the recent higher growth rates will lead to more inflation. Higher long interest rates, now assisted by the Fed's boost in short rates, will exert a powerful damping force on the economy. With low inflation at present, we can expect any tendencies toward future higher inflation to be quickly crushed as our economy soon begins to slow.