THE COMPASS

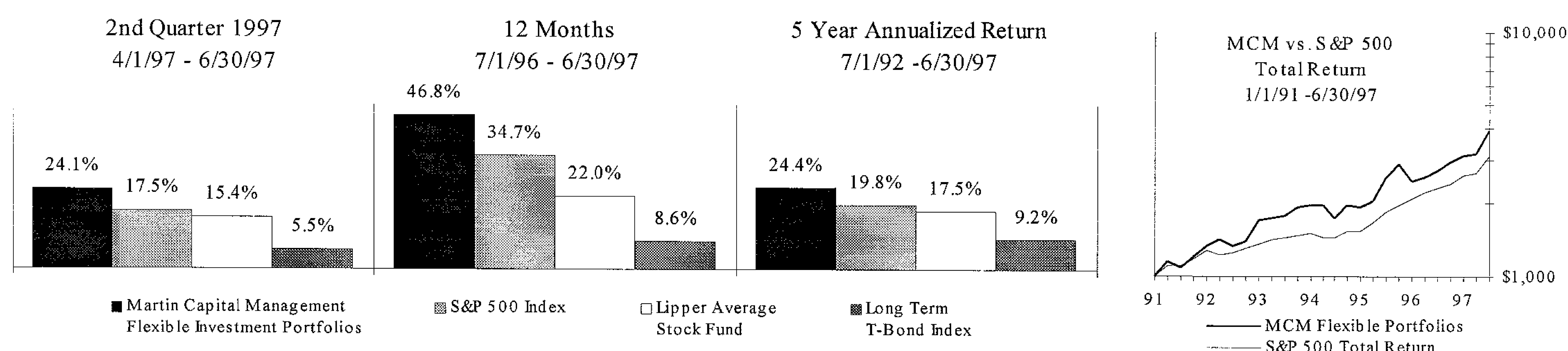
A QUARTERLY NEWSLETTER FROM MARTIN CAPITAL MANAGEMENT

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

July 1, 1997

DJIA 7672.79 / S&P 500 885.14 / NASDAQ Comp. 1442.07 / Wilshire 5000 8396.87 / Long T-bond Index 6.85% (6792.59)
3 month T-Bill rate 5.13% / Federal Funds Rate 5.50% / Discount Rate 5.00% / Prime Rate 8.50% / Inflation (CPI) 2.5%
Federal Reserve Dollar Index 95.67/ Oil $19.80 / Gold $334.20 / GDP (1Q) 5.8%

Investment Results



Investment Perspective

Second quarter stock market returns were spectacular. After the first quarter's rally and subsequent sell-off back to beginning of the year levels the market was well positioned for the second quarter's explosive run. The stock market took off as sentiment shifted from concerns about further interest rate hikes to the notion that the economy might be slowing to a sustainable pace without additional Federal Reserve intervention. On the other hand, despite remarkably benign inflation statistics, the impressive resilience of the economy in the face of relatively high interest rates tempered the performance of fixed income securities. For the quarter, the stock market achieved much higher returns than our 5% expectation, while the bond market was not quite as strong as our 10% performance projection.

Third quarter stock market returns will be influenced by the usual suspects – economic growth and interest rates. As long as growth stays in the 2% to 4% range and interest rates are stable the stock market will do fairly well. If economic growth slows below 2%, then the stock market will weaken in anticipation of lower earnings, but bonds will improve as inflation concerns are reduced. If economic growth moves back above 4%, then the stock market may sell off in anticipation of higher interest rates. Our guess for now is that the "Goldilocks economy" - not too strong and not too weak - will continue through the end of the year, in which case both the stock and bond markets should stay on coarse for above average returns. We will be vigilant in watching for signs of a significant correction, but for the time being we will continue to ride the bull.

The history of stock market performance proves that short-term timing should be used sparingly. Contrary to the contingent of bearish prognosticators, the stock market does go up over time (10.5% per year compounded since 1926). It's remarkable that so many intelligent people can remain bearish for years on the prospects for the stock market because valuations are "too high" and the market has gone up "too much." High valuations are warranted in today's dis-inflationary and robust global economy. Just as happens with a high-flying stock, however, anytime the consensus decides that near-term growth is in question, there's a rush to bail out. The problem is that even if a significant downturn is avoided, the likelihood of jumping back on board in time for the ride to higher highs is rather small. Though "crashes" may occur from time to time, the economy and the stock market will survive to fly another day. If they don't, then it's the end of the world and the poor performance of investment portfolios will be irrelevant.

Recommended Flexible Asset Allocation

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

Market Timing Viewpoint

	Three Month Performance Expectation					
	Optimistic		Most Likely		Pessimistic	
	Target	%Change	Target	%Change	Target	%Change
DJIA/S&P 500	8400/975	+10.0%	8050/930	+05.0%	6900/800	-10.0%
Nasdaq	1585	+10.0%	1500	+05.0%	1300	-10.0%
T-Bond Index	6.1%	+10.0%	6.4%	+05.0%	7.10%	-05.0%

20 Largest Common Stock Positions

(Prices as of June 30, 1997)

1	Dell Computer	117.44	6	Whole Foods Mkt	33.13	11	Electronic Arts	33.63	16	3 Com	45.00
2	Charles Schwab	40.50	7	Hewlett-Packard	56.00	12	Advanced Micro Dev	35.88	17	Southwest Airlines	25.88
3	Intel	141.81	8	Cisco Systems	67.13	13	Motorola	76.13	18	CompUSA	21.50
4	Applied Materials	70.81	9	Texas Instrument	84.06	14	Oracle	50.38	19	Chrysler	32.88
5	Microsoft	126.38	10	Williams-Sonoma	42.75	15	Home Depot	69.00	20	Tiffany	46.19

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%	- 0.8%	+ 5.0%	+ 3.3%
1997 YTD	+ 27.2%	+ 19.1%	+ 20.6%	+ 17.7%	+ 2.1%	+ 2.5%	+ 1.3%
Total**	+307.5%	+252.5%	+219.4%	+216.5%	+ 85.1%	+ 31.5%	+ 20.2%
Avg.***	+ 24.1%	+ 21.4%	+ 19.6%	+ 19.4%	+ 9.9%	+ 4.3%	+ 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.

*** 6.5 year annualized return (1991 - 1997).

(AIMR performance presentation is available on request. / 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

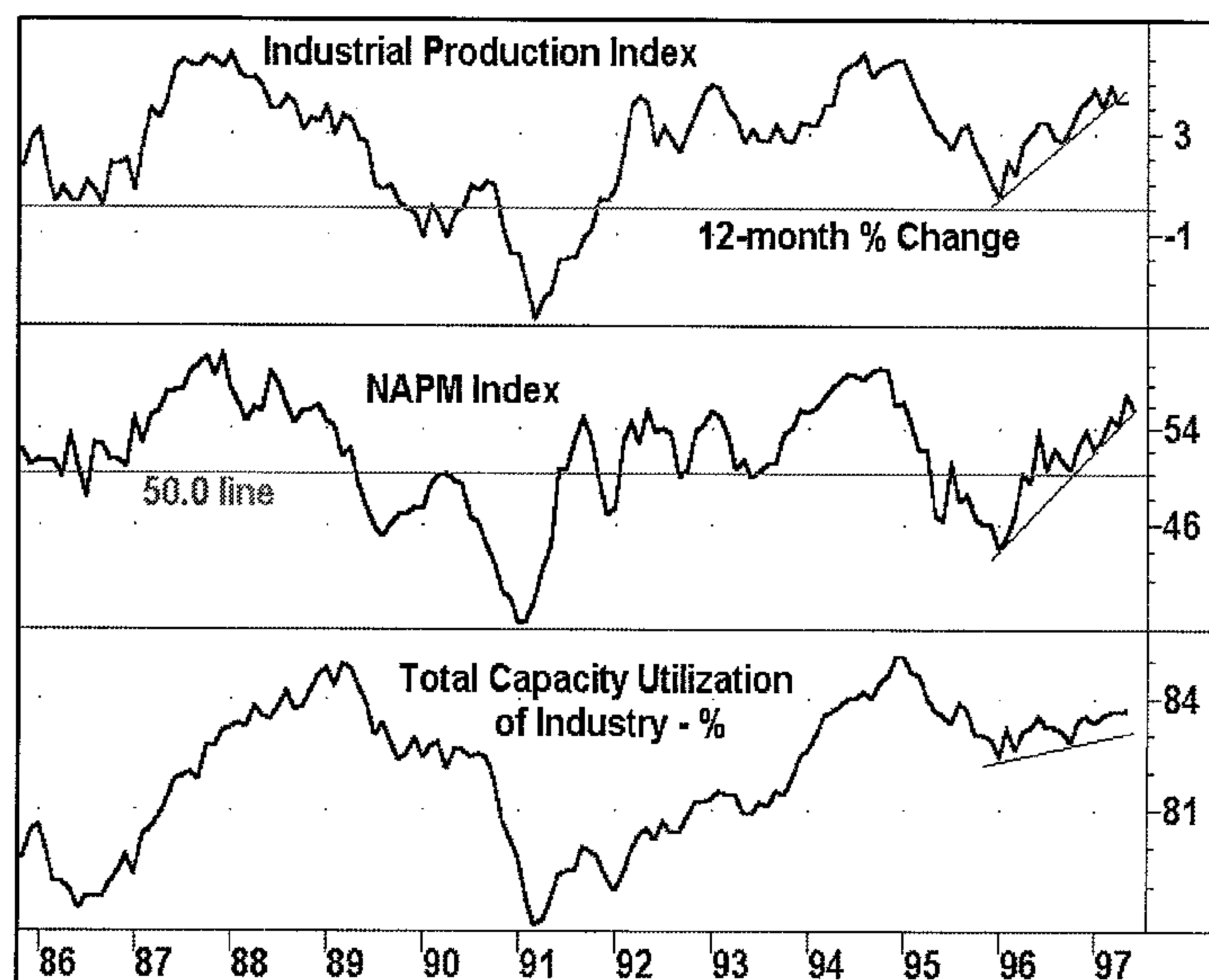
Market and Economic Statistics as of Close on June 30, 1997, with 3-month & 12-month Changes

Stock Indexes*		3 mo	12 mo	Interest Rates		3 mo	12 mo	Prices, Inflation		3 mo	12 mo
Dow Industrials	7673	16.5%	35.7%	91-day T-Bill DR	5.10%	-2.1%	1.2%	CPI, May	160.2	1.0% apr	2.4%
S&P 500	885	16.9%	32.0%	30-yr T-Bond Yld	6.78%	-4.4%	-1.6%	PPI, May	131.2	-3.9% apr	0.3%
NYSE Comp Ind	462	16.0%	28.7%	FNMA 30yr mortg	7.76%	-6.6%	-5.3%	Gold, cash - H&H	333.70	-4.4%	-12.2%
NASDAQ	1442	18.0%	21.7%	Prime Rate	8.50%	0.0%	3.0%	W Tx Int Cr Oil	19.76	-3.4%	-5.2%
Wilshire 5000	8400	16.4%	27.0%	Fed Funds Trgt	5.50%	0.0%	4.8%	CRB Futures Ind	239.42	-2.3%	-3.7%
Russell 2000	396	15.7%	14.4%	Fed Disc Rate	5.00%	0.0%	0.0%	CRB Raw Indust	335.65	-0.8%	1.0%

* excluding dividends

Money				Industry				Economy			
M2, Bil Curr$, May	3901	0.9%	4.7%	Indust Prod Ind, May	119.7	1.1%	4.3%	GDP, 1st Qtr	7094.4	5.8% apr	4.1%
Free Reserves	1045	25.9%	80.5%	NAPM Ind, June	55.7	0.7	1.9	Unemplmt %, June	5.0	-0.2	-0.3
Money Mkts - Bil$	968	0.3%	18.8%	Cap Util, May - %	83.7	0.2	0.5	Leading Indic, May	103.8	0.4%	1.7%

The tables above show that big cap stocks as a group have left small caps in the dust: the Dow Industrials and the S&P 500 have increased more than twice as much as the small cap Russell 2000 Index in the past 12 months. Interest rates have been relatively steady, with very little change over 3 and 12 months. The 91-day T-bill rate has been roughly only 0.25% higher and the 30-year T-bond 0.60% higher than today during the past 12 month period. Both rates have been only slightly lower. By historical standards, this is a very narrow range over a 12-month period. The steadiness of interest rates has been due in large measure to the equally steady rate of and outlook for inflation. The Consumer and Producer Price Indices show low and declining rates of increase. Commodity prices also reflect this same trend toward disinflation. Rapid growth in the Gross Domestic Product, high levels of industrial activity and a very low unemployment rate, all historically dangerous for prospects of higher inflation, have not managed to create any problem in that regard.



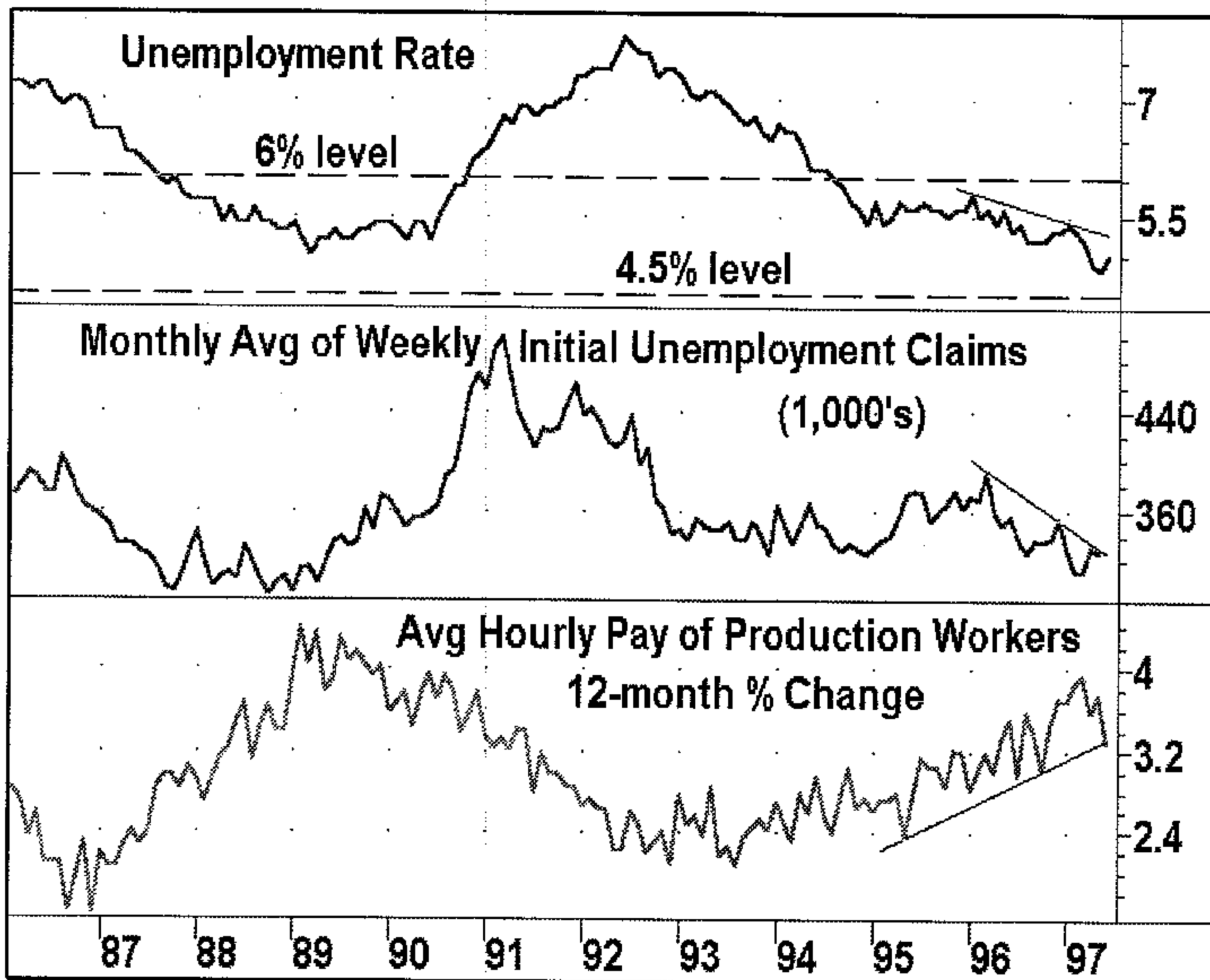
MANUFACTURING The upward trends on the charts of the Industrial Production Index and the North American Purchasing Managers' survey illustrate the expansion that has taken place in the industrial sector of our economy since early 1996. These 2 indices are approaching the highs reached in 1987 and 1994. Total capacity utilization of industry has increased but not as fast as the other 2 measurements. The fact that capacity utilization has remained relatively steady has helped avoid bottlenecks in production and delivery of products that might have led to price increases. The steadiness has been a result of more efficient management and of increased capacity. In the midst of the signs of expansion in the manufacturing sector come a few tentative signs of a slowdown, which are welcome after the strong spurt of growth in the 1st quarter of the year. The U.S. Gross Domestic Product increased at an annual rate of 5.8% during those 3 months, the fastest quarterly growth rate since 1987. Durable goods orders declined 0.6% in May, after a 1.8% increase in April. Construction spending fell 1.8% in May, after an increase of 0.3% in April. Housing starts fell 4.8% in May, but new home sales showed a reversed pattern: an increase of 7.1% in May, following a decrease of 8.1% in April. The latest figures from April for manufacturers' new orders for consumer goods were slightly higher than the month before but showed a pattern of slowing. All together, manufacturing activity has been increasing sharply, but evidence of slowing is beginning to appear.

SALES Retail sales fell 0.1% in May, a surprise, as an increase of 0.4% had been expected. This marked the 3rd consecutive monthly decline, the first time that has occurred since the recession of 1981. As consumer spending drives about 2/3 of our economy, this was particularly worthy of note. Auto and light truck sales reached an all-time high in March, then dropped about 10% in April to the lowest level in 2 years. May saw a weak recovery. The manufacturers' inventory to sales ratio has remained steady, without any

significant buildup or drawdown. Consumer sentiment has reached highs not seen for nearly 30 years, helped by a strong labor market where workers have fewer fears of losing their jobs. In the past, such confidence has often led to more open wallets, and it may have helped trigger the burst in consumer spending early this year. That burst, however, seems to be slowing.

CREDIT An interesting divergence developed between commercial and consumer loans. Their rates of increase or decrease usually tend to parallel each other. Since early 1996, however, the rate of increase in commercial loans has increased substantially, while consumer installment loans have been tapering off. A possible explanation is that as more jobs have become available, consumers have had less need to borrow. The ratio of consumer installment credit to personal income peaked at an all-time high last October and has dropped slightly since then. The expansion in consumer spending during the first quarter of 1997 evidently came out of cash from wages rather than from credit cards, a healthy sign. As consumer spending seems to have slowed lately, perhaps the extra income has been shifted over to savings, which could be a bonus for the economy in the long run.

LABOR The expansion that has taken place in manufacturing has led to the hiring of additional workers as a part of the process, leading to a tighter the labor market. The recent, relatively steep trends in the charts of labor statistics seen to the left all begin close to the time of the beginning of the surge in manufacturing, shown in the charts on the previous page. The unemployment rate reached a low of 4.8% in May, a level not seen since 1973. The rate rose to 5.0% in June, another indication of slowing in the economy, and a relief to inflation hawks. The 6% level has been regarded by many as the NAIRU, or non-accelerating inflation rate of unemployment, the threshold of tightness in the job market that would produce inflation. This has proven not to be the case, as we have continually experienced unemployment rates under 6% since late 1994 without incurring more inflation. During the 1950's and early 1960's, the onset of increased inflation came with an unemployment rate below 4.5%. The average of initial unemployment claims has fallen as fewer workers have been let go from their jobs, another indication of an increasingly tight labor market. The rate of change of average hourly pay of production workers, directly reflecting the possibility of wage inflation, has also been trending up. The latest figure, however, actually appears to have dropped slightly below the trendline on the chart. Considering other signs of slowing in the economy, there is a possibility that it might extend even lower. In any case, the latest rate of increase in hourly wages is 3.3% in 12 months, only 1.0% more than the overall rate of inflation indicated by the Consumer Price Index. The help wanted index dropped from 87 in April to 81 in May, the lowest level since last August, a further indication of slowing growth in jobs. In summary, the labor market has been tight but shows signs of easing. Although the source of the Fed's greatest worries about increased inflation, wages do not appear to be at the point of creating a problem under today's conditions.



INFLATION Evidence of inflation in the U.S. economy is virtually impossible to find. The inflation rate indicated by the Consumer Price Index, the measurement most accepted for the overall economy, is 2.3% over the last 12 months. Inflation of prices at the wholesale level, as indicated by the Producer Price Index, is down to 0.2% per year. The PPI has experienced 3 consecutive monthly declines, the first time that has occurred since 1952. A third measurement is the Implicit Price Deflator, used in calculating the inflation-adjusted GDP, which shows an overall inflation rate of only 1.3%. The price of gold slid below \$334/oz, the lowest since early 1993. Part of this drop has been the result of a strong U.S. dollar, but gold prices could not have fallen this low if widespread fears of inflation were present. The price of oil has dropped back below \$20/bbl, good news for prospects of a still further reduced inflation rate and bad news only for those who make their living in the oil patch. None of the many commodity price indices are indicating any inflation in commodity prices. Capacity utilization of industry is not high enough to cause problems. Slow deliveries by suppliers, a part of the NAPM index, can be an indication of shortages and bottlenecks in the supply line if widespread. These are not at problematic levels. At this moment, the labor market appears to be the only area with the potential for a problem with inflation any time in the near future.