THE COMPASS

A QUARTERLY NEWSLETTER FROM MARTIN CAPITAL MANAGEMENT

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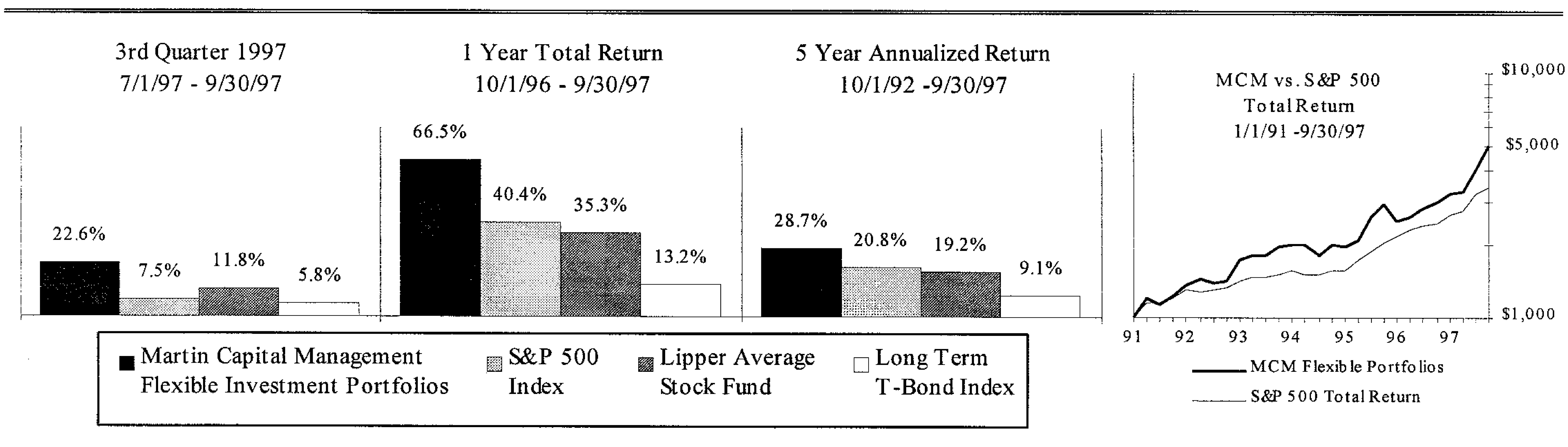
October 1, 1997

DJIA 7945.26 / S&P 500 947.28 / NASDAQ Comp. 1685.69 / Wilshire 5000 9180.21 / Long T-bond Index 6.46% (7184.77)
3 month T-Bill rate 4.97% / Federal Funds Rate 5.50% / Discount Rate 5.00% / Prime Rate 8.50% / Inflation (CPI) 2.2%
Federal Reserve Dollar Index 96.92 / Oil $21.18 / Gold $334.30 / GDP (2Q) 3.3%

Investment Results



Investment Perspective

Third quarter stock and bond market returns were in line with our positive projections. Contrary to the concerns of many economists and investment professionals, the economy did not become too hot or too cold, but remained just right through the end of the quarter. Three months ago, stock and bond market bears were disdainful of anyone who suggested that moderate growth with low inflation could possibly continue for any length of time. The prevailing viewpoint, which still continues today, was that the economy would overheat and the Federal Reserve Board would have to hike interest rates, resulting in a significant correction, if not a bear market, for both stocks and bonds. We disagreed with that position, and achieved an average return of 22.6% for the quarter.

The fourth quarter is more difficult to gauge than recent quarters. Though the first month or two should be fairly positive, the last part of the quarter through the beginning of next year may be troublesome for the stock market. The catalyst for a significant stock market correction could be a weakening economy that threatens to hurt corporate earnings. Of course, the bond market would do quite well in such a scenario. It is not clear at this time whether interest rates will drop fast enough to mitigate a potential economic malaise and consequent corporate earnings decline. Our best guess is that bonds may begin to significantly outperform stocks by the end of the year. Accordingly, we are increasing our recommended bond allocation by 5%, and decreasing our recommended stock allocation by 5%, as shown in the box below. We will reassess these allocations as a clearer picture of the strength or weakness of the economy develops over the next few months.

Nelson's World's Best Money Managers (http://www.nelnet.com) now rates Martin Capital Management # 1 in tactical asset allocation performance for the quarter, one year, three years and five years ending June 30, 1997. This success could not have been achieved without the faith and trust of our clients who stayed with us through occasional periods of poor performance. The real test for any investor or investment professional is not what they do when the markets are going their way, but, rather, how they handle times when the markets are going against them. We are proud of the success we have achieved for our clients and ourselves, yet we know that there will be difficult periods of poor performance again in the future to challenge our confidence. However, given the global economy's historically positive bias, we know that long-term success is assured as long as we maintain a steady course through the sporadic waves of stock market turbulence.

Recommended Flexible Asset Allocation

Stocks	85%	(Δ – 5%)
Bonds	15%	(Δ + 5%)
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	8700/1050	+10.0%	7950/950	+00.0%	6750/800	-15.0%
Nasdaq	1850	+10.0%	1675	+00.0%	1400	-15.0%
T-Bond Index	5.50%	+15.0%	5.75%	+10.0%	6.75%	-05.0%

20 Largest Common Stock Positions

(Prices as of September 30, 1997)

1	Dell Computer	96.88	6	Microsoft	132.21	11	Williams-Sonoma	42.75	16	3 Com	51.25
2	Charles Schwab	35.75	7	Hewlett-Packard	69.56	12	Electronic Arts	38.63	17	Motorola	71.88
3	Intel	92.31	8	Whole Foods Mkt	38.63	13	Southwest Airlines	32.00	18	Advanced Micro Dev	21.50
4	Applied Materials	95.25	9	Cisco Systems	73.06	14	Oracle	36.44	19	Cyrix	33.50
5	Texas Instruments	134.00	10	CompUSA	35.00	15	Home Depot	52.13	20	Computer Associates	71.81

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	+ 55.9%	+ 25.0%	+ 29.6%	+ 29.1%	+ 8.0%	+ 3.8%	+ 1.7%
Total**	+399.2%	+276.5%	+243.3%	+247.3%	+ 95.8%	+ 33.1%	+ 20.7%
Avg.***	+ 26.9%	+ 21.7%	+ 20.1%	+ 20.3%	+ 10.5%	+ 4.3%	+ 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.

*** 1991 - 1997 YTD annualized return

(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, trusts, and pension plans.

MARTIN CAPITAL MANAGEMENT
QUARTERLY ECONOMIC REVIEW

by Alston Boyd

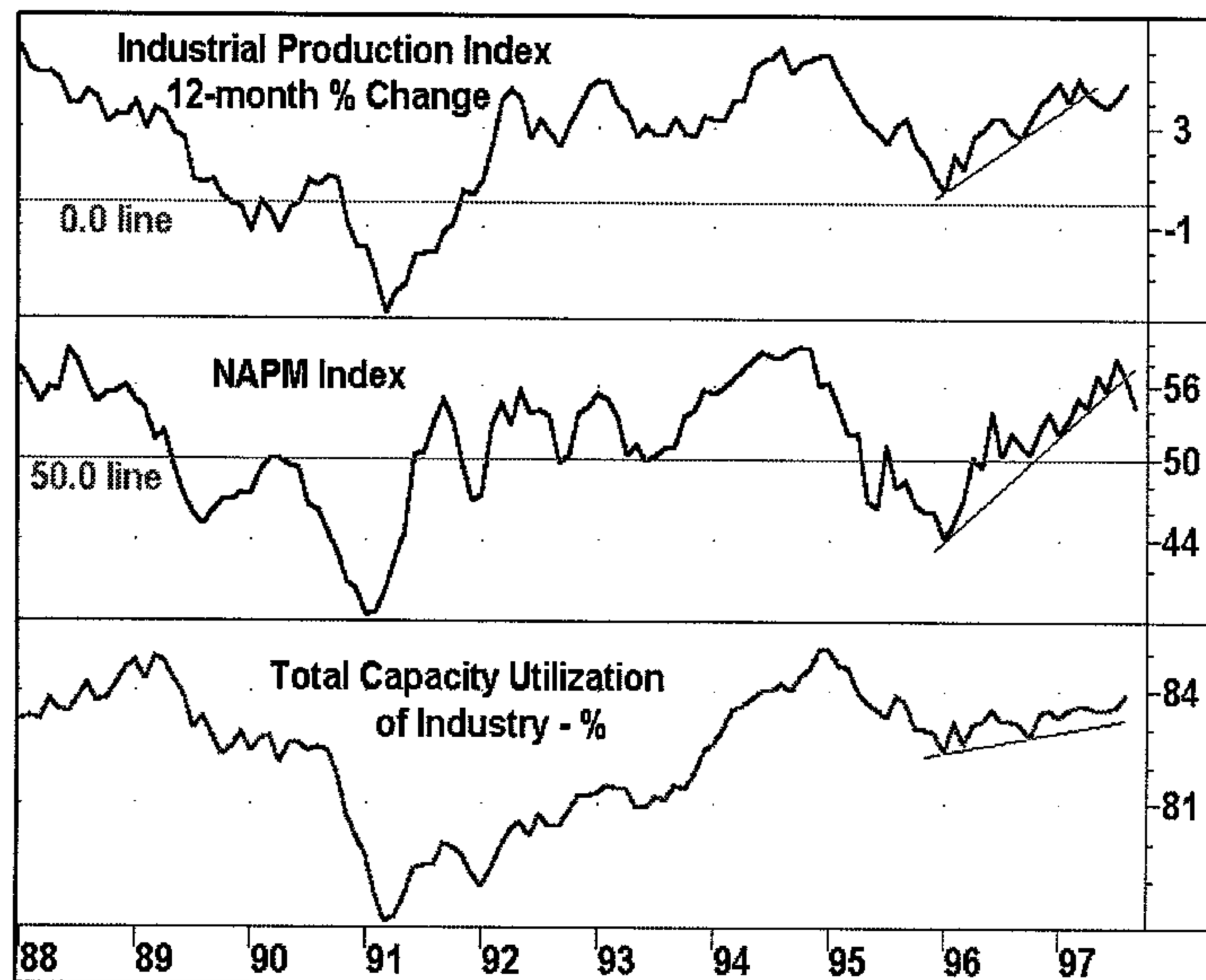
Market and Economic Statistics as of Close on September 30, 1997, with 3-month & 12-month Changes

Stock Indexes*		3 mo	12 mo	Interest Rates		3 mo	12 mo	Prices, Inflation		3 mo	12 mo
Dow Industrials	7945	3.6%	35.1%	91-day T-Bill DR	4.97%	-2.5%	1.2%	CPI, Aug	160.9	2.0% apr	2.2%
S&P 500	947	7.0%	37.8%	30-yr T-Bond Yld	6.40%	-5.6%	-7.5%	PPI, Aug	131.4	0.6% apr	-0.2%
NYSE Comp Ind	497	7.5%	35.4%	FNMA 30yr mortg	7.40%	-4.6%	-10.3%	Gold, cash - H&H	332.1	-0.5%	-12.7%
NASDAQ	1685	16.9%	37.4%	Prime Rate	8.50%	0.0%	3.0%	W Tx Int Cr Oil	21.15	7.0%	-13.3%
Wilshire 5000	9180	9.3%	35.7%	Fed Funds Trgt	5.50%	0.0%	4.8%	CRB Futures Ind	243.1	1.5%	-1.1%
Russell 2000	454	14.5%	31.0%	Fed Disc Rate	5.00%	0.0%	0.0%	CRB Raw Indust	336.7	0.3%	-0.7%

* excluding dividends

Money				Industry				Economy			
M2, Bil Curr$, Aug	3966	1.6%	5.4%	Indust Prod Ind, Aug	121.3	1.5%	4.7%	GDP-Bil$, 2nd Qtr	7159.6	3.3% apr	3.4%
Free Reserves	691	-33.9%	20.4%	NAPM Ind, Sept	54.2	-0.3	4.7	Unemplmt %, Sept	4.9	0.1	-0.3
Money Mkts - Bil$	1028	6.2%	21.4%	Cap Util, Aug - %	83.9	0.4	0.7	Leading Indic, Aug	104.3	0.6%	1.9%

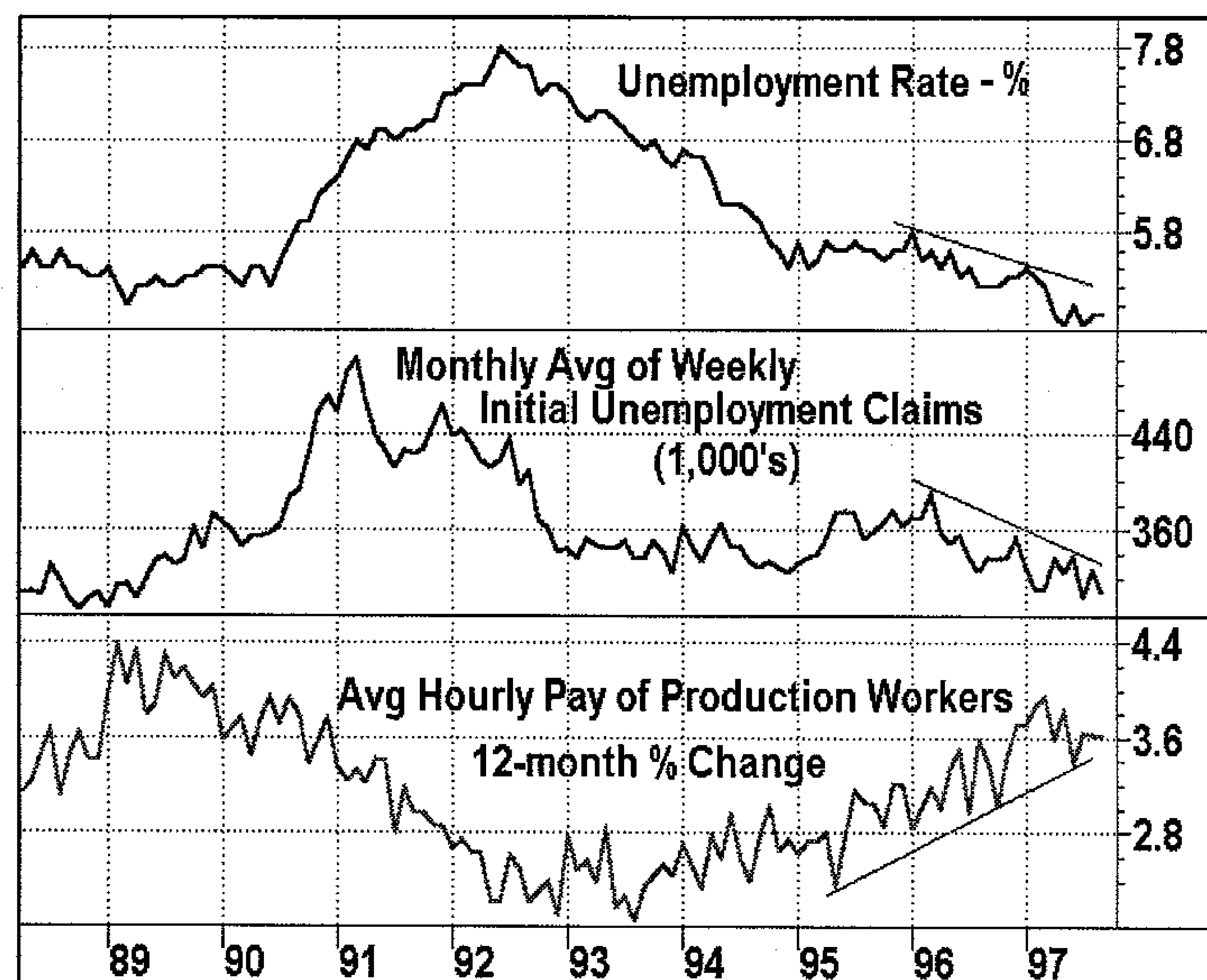
The tables above show evidence of one of the best years in history for the stock market, with all indices listed having increased more than 30% in 12 months. Growth over the past 3 months in the Russell 2000 and the NASDAQ has been 4 times that of the Dow Industrials. Small-cap and high-tech stocks have been catching up with the growth of the big-cap industrials, which led the steep advance. In the credit markets, most short rates have increased slightly over 12 months, while long rates have declined. Both of these trends contribute to a flattening of the yield curve, as short and long rates have come closer together. Despite fears to the contrary, relatively high rates of economic growth combined with very low unemployment have not managed to provoke any increase in the overall rate of inflation. Indicators of inflation remain quiescent, showing no danger to our economy from that direction.



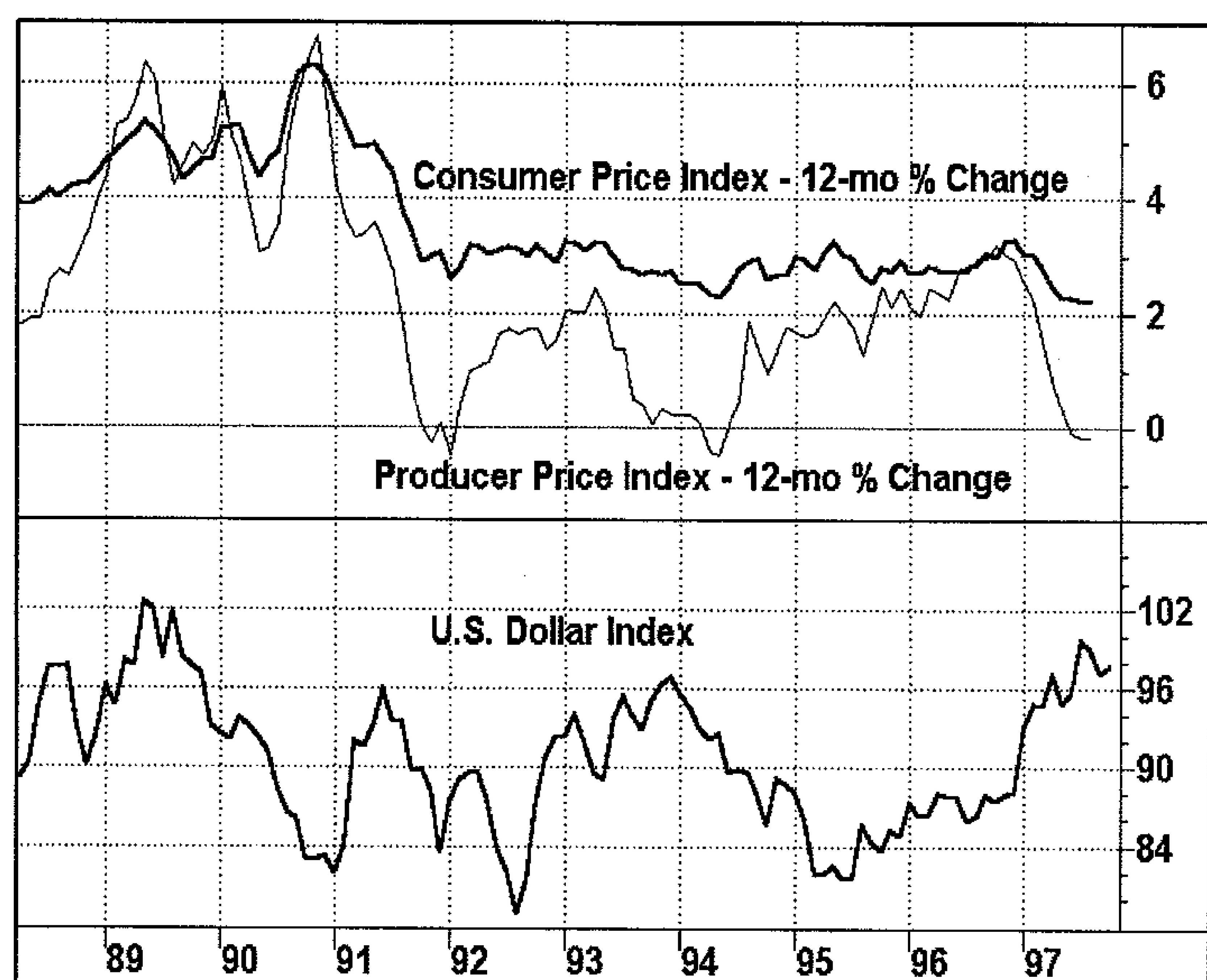
MANUFACTURING The rate of growth in the manufacturing sector of our economy appears to have leveled off. The rate of change in the Industrial Production Index, top chart at right, had been on a steep upward trend until 3 consecutive declines in April, May and June. The trend has turned upward again, but the high of last March has not been equaled. The North American Purchasing Managers Index broke its steep upward trend with 2 consecutive monthly declines in August and September, a welcome sign confirming the previous break in the Industrial Production Index. Although growth still remains strong and healthy, the change in trend is away from dangerous territory of too-rapid expansion. Capacity utilization of industry has crept upward since early 1996, although not at the rapid rate of increase shown by industrial production and the NAPM Index. The slower climb in this measurement has been the result of increased capital spending and the addition of plants and other facilities to handle the increased production. The trend toward adding capacity continues, as manufacturers new orders for durable goods and for capital goods have been increasing at a higher rate than consumer goods. The number of building permits for new private housing declined 4 of the last 5 months, while housing starts were down 11.1% in August from a year earlier. The contraction in this sector will most likely not last with interest rates on home mortgages declining to near 18-month lows.

SALES Retail sales have been strong this year, up 0.4% for the month of August and up 5.3% over 12 months. The monthly increase in August was the smallest in 3 months, providing some relief to those who had feared that very strong retail sales might propel economic growth up to levels unsustainable without bringing on the dreaded inflation monster. As consumer spending dominates 2/3 of our economy, this retail sales figure has been closely watched from month to month. Seasonally adjusted auto and light truck sales were little changed in August over July. The total sales figure of 16 million units was near a record, although it was up only 1.4% over 12 months.

LABOR The labor market remains tight, with an unemployment rate of 4.9% during the last 2 months. The 4.8% rate seen in May and July of this year was a low not seen since 1973. In spite of this, wages are not accelerating in an alarming manner. Initial unemployment claims, a measure of numbers of workers laid off, has continued to decline, confirming the picture of the tight labor market. Labor has been regarded for more than a year as the most likely place for inflation to break out, but expectations of a surge in wages simply have not been fulfilled. Hourly pay of production workers increased 3.6% over 12 months, extending the upward trend of the change in hourly wages that began in mid-1993. Even though the latest figure lies above the trendline drawn on the chart, we seem to be at a point now where the rate of increases in hourly wages may have reached a plateau. This is encouraging because there is a limit to the amount of wage increases that can be offset in other areas like productivity and lower raw materials prices. Without such a pause or plateau in the rate of increase, we would have far more cause to worry about wage inflation. The quarterly figure for unit labor costs, which includes benefits as well as wages, increased at an annual rate of 2.2% in the second quarter, less than the hourly wage figure. The index of labor costs per unit in manufacturing fell to 98.6, the lowest level since 1990. That index is adjusted for inflation and takes the average of 1992 as being equal to the benchmark of 100.0. This latest reading means that labor costs per unit manufactured are dropping relative to inflation and that labor costs are in no way inflationary at present.



INFLATION The most widely accepted measure of inflation in our economy is the 12-month change in the Consumer Price Index, which was up only 2.2% in August. The Producer Price Index of wholesale prices was actually down 0.5% in 12 months. The main difference between the two indices is the cost of services, a segment of the CPI which includes a large component of labor costs. The PPI includes many raw materials prices, which have mostly remained flat or have declined. The rate of increase in labor costs is somewhat higher than raw materials and has thus pushed the CPI rate of increase higher. The impact on the CPI of the acceleration of wages seen since 1993 has so far been offset by improved productivity and by flat to lower raw materials prices. One reason we have seen commodity prices and the PPI decline is that we have had a very strong U.S. dollar in 1997 (see bottom chart). Any commodity with a stable price in the world market has become cheaper in terms of dollars and more expensive in terms of any weaker currency. The prices of both gold and oil, both of which have a big impact on the financial markets, began to climb near the end of September for different reasons. The price of gold has always been tied to that of silver. As silver prices have risen because of industrial demand, gold has risen in response. The recent rise in oil prices has been the result of Iran making aggressive moves toward Iraq. This is a reminder of the ever-present instability in the Persian Gulf and the ability of that region to impact the world economy. Although the U.S. is the Great Satan to both Iran and Iraq, we are the world power that rides to the rescue of stability and the assurance of a continued flow of oil from that region to the rest of the world. The chances of this disturbance erupting into something more significant and of oil prices remaining higher are slim, and without a more significant outbreak of hostilities, oil prices should slip back down below $20 per barrel over the next month or so.



SUMMARY The U.S. economy continues to walk a very fine line, managing to achieve relatively fast growth without edging too close to the slippery slope that leads into the fires of inflation. The increase in GDP has been greater than an annualized rate of 3% for the last 3 quarters and unemployment is near a 30-year low. Nevertheless, the rate of inflation indicated by the Consumer Price Index remains at 2.2% over 12 months. The rate of growth in industry seems to have paused and the increasing tightness in the labor market appears to have moderated, at least in the short term. Barring the upticks in gold and oil prices at the very end of the quarter, we are seeing the best of possible combination of factors for continued steady growth in our economy and financial markets. Adding to this rosy picture are conditions in the world economy. Many Asian countries (excluding China) are having difficulties stemming from currency problems. The weakness in their economies leaves room for ours to expand with less strain on worldwide supplies and capacity.