THE COMPASS

A QUARTERLY NEWSLETTER FROM MARTIN CAPITAL MANAGEMENT

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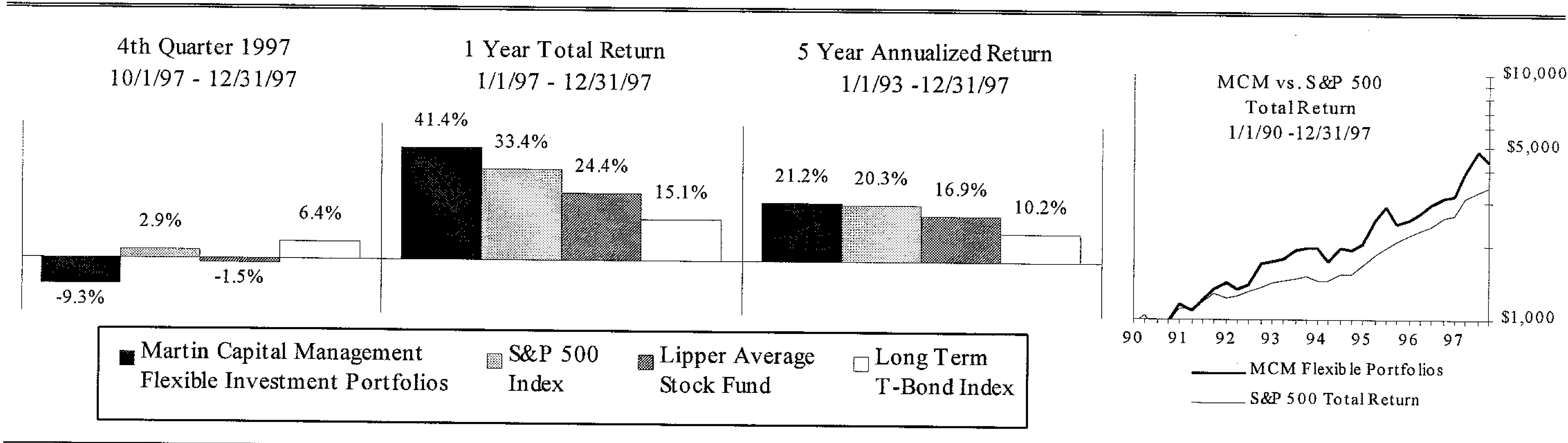
January 1, 1998

DJIA 7908.25 / S&P 500 970.43 / NASDAQ Comp. 1570.35 / Wilshire 5000 9298.19
Federal Reserve Dollar Index 99.57 / Long T-bond Index 6.00% (7644.99)

Investment Results



Recommended Flexible Asset Allocation

Stocks 85% (Δ unch)	Bonds 15% (Δ unch)	Cash 0% (Δ unch)

Investment Perspective

The last quarter of 1997 proved to be as treacherous for stocks as we had feared. We were somewhat surprised, however, by the severity of the sell-off at the end of October. As we speculated in the last newsletter, the catalyst for the correction turned out to be concerns over a potentially weakening economy and reduced corporate profits. Though the S&P 500 managed to recover by the end of the quarter, our portfolios were held down by the poor performance of the technology sector. As anticipated, bonds outperformed stocks for the quarter.

There will probably continue to be further weakness in stocks and strength in bonds through the beginning of the first quarter of 1998. Later in the quarter, or at least by the beginning of the second quarter, there should be a strong stock market rally when it becomes apparent that corporate earnings are not going to be quite as negatively impacted by Asia's economic woes as the present stock market volatility would suggest. While everyone worries about a slowdown in sales to Asia, they forget that expenses for US companies will come down even more in the wake of lower costs for Asian parts and products. Though the economic problems in Asia will have a dampening effect on the world economy for some time into the future, U.S. corporate profits should remain fairly robust as the year progresses. Bonds will continue to benefit well into the first quarter from concerns about Asia's potential impact on the health of the U.S. economy. By the end of the quarter, bonds may begin to give back some of their recent gains, but they should still finish with a positive performance.

Nelson's *World's Best Money Managers* (http://www.nelnet.com) has again rated Martin Capital Management # 1 in U.S. Tactical Asset Allocation performance for the quarter, one year, three years and five years ending September 30, 1997. In addition, we were rated # 1 in U.S. Balanced/Multi-Asset (All Styles) performance for all periods up through five years. Unfortunately, our poor fourth quarter relative performance means that we will fall back in the ratings for the end of the year when they are posted sometime in March. We are confident, however, that our long-term bullish orientation will prevail in lifting our performance back to the top as the greatest bull market of the twentieth century climbs ever higher into the twenty-first century.

Market Timing Viewpoint

	Performance Expectation					
	March 31, 1998		December 31, 1998		December 31, 2002	
	Target	%Change	Target	%Change	Target	%Change
DJIA/S&P 500	7900/975	+00.0%	8700/1075	+10.0%	16000/2000	+100.0%
Nasdaq	1650	+05.0%	1800	+15.0%	3600	+130.0%
T-Bond Index	5.75%	+05.0%	5.50%	+10.0%	4.50%	+25.0%

20 Largest Common Stock Positions

(Prices as of December 31, 1997)

1	Dell Computer	84.00	6	Applied Materials	30.13	11	Home Depot	58.88	16	Motorola	57.19
2	Charles Schwab	41.94	7	Cisco Systems	55.75	12	CompUSA	31.00	17	Sprint	58.63
3	Whole Foods Mkt	51.13	8	Hewlett-Packard	62.38	13	Williams-Sonoma	41.88	18	Travelers	53.88
4	Intel	70.25	9	Texas Instruments	45.00	14	Electronic Arts	37.81	19	3 Com	34.94
5	Microsoft	129.25	10	Southwest Airlines	24.63	15	Computer Associates	53.00	20	Chrysler	35.19

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
1990	- 2.5%	- 0.5%	- 3.2%	- 6.2%	+ 6.3%	+ 5.9%	+ 6.1%
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%	+ 37.6%	+ 36.5%	+ 30.7%	+ 5.5%	+ 2.6%
1996	+ 29.3%	+ 29.1%	+ 23.0%	+ 21.2%	- 0.8%	+ 5.0%	+ 3.3%
1997	+ 41.4%	+ 24.9%	+ 33.4%	+ 31.3%	+ 15.1%	+ 5.1%	+ 1.8%
Total**	+341.6%	+269.1%	+242.4%	+231.3%	+119.2%	+ 42.7%	+ 28.2%
Avg.***	+ 20.4%	+ 17.7%	+ 16.6%	+ 16.2%	+ 10.3%	+ 4.5%	+ 3.2%

* 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.

*** 1990 - 1997 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 for individuals, trusts, and pension plans.

MARTIN CAPITAL MANAGEMENT
QUARTERLY ECONOMIC REVIEW

by Alston Boyd

Market and Economic Statistics as of Market Close on December 31, 1997, with 3-month & 12-month Changes

Stock Indexes*		3 mo	12 mo
Dow Industrials	7908	-0.5%	22.6%
S&P 500	970	2.4%	31.0%
NYSE Comp Ind	511	2.8%	30.3%
NASDAQ	1570	-6.8%	21.6%
Wilshire 5000	9298	1.3%	29.2%
Russell 2000	437	-3.7%	20.5%

* excluding dividends

Interest Rates		3 mo	12 mo
91-day T-Bill DR	5.21%	4.8%	3.0%
30-yr T-Bond Yld	5.92%	-7.5%	-11.0%
FNMA 30yr mortg	7.18%	-3.0%	-7.2%
Prime Rate	8.50%	0.0%	3.0%
Fed Funds Trgt	5.50%	0.0%	4.8%
Fed Disc Rate	5.00%	0.0%	0.0%

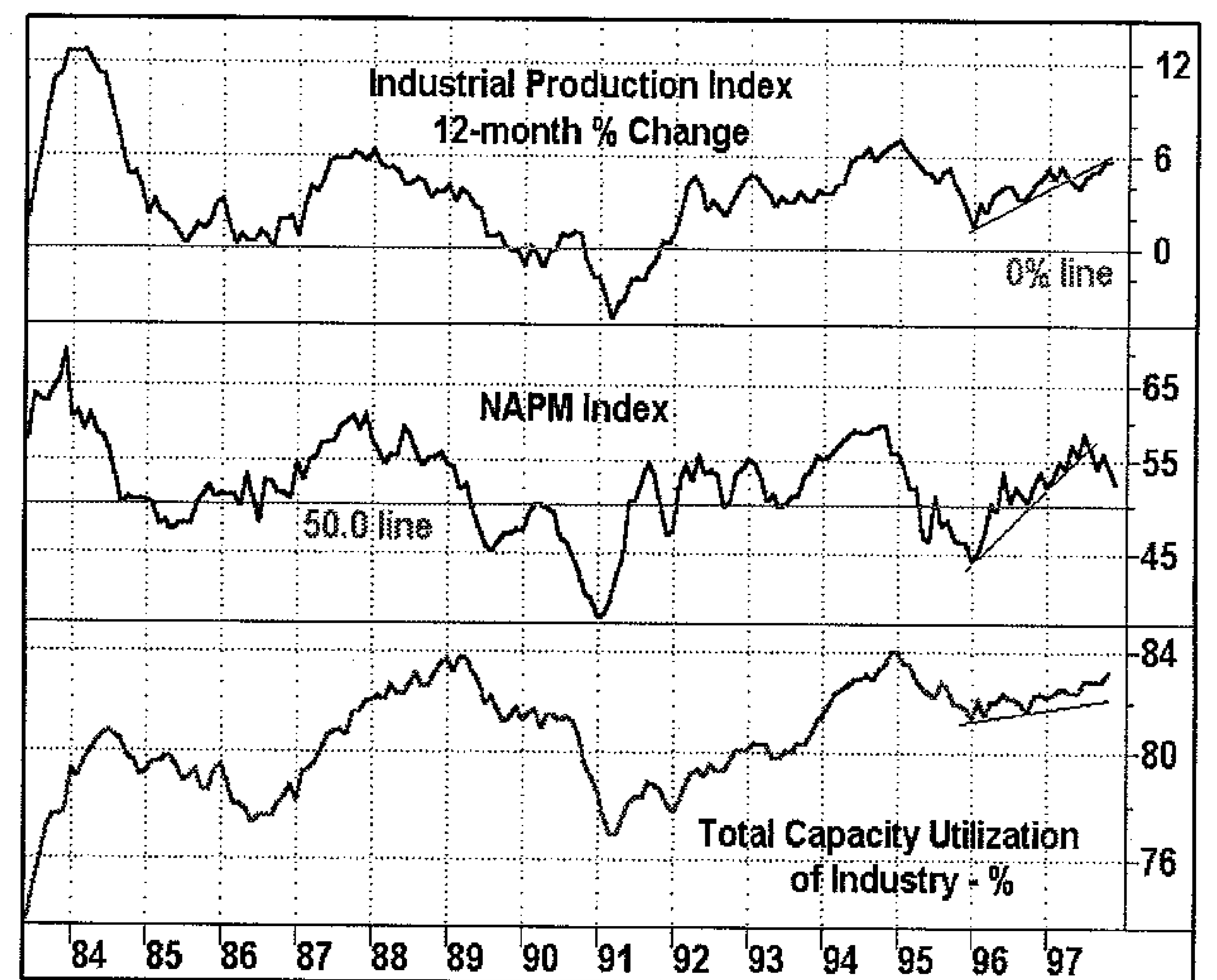
Prices, Inflation		3 mo	12 mo
CPI, Nov	161.7	2.0% apr	1.8%
PPI, Nov	131.9	1.4% apr	-0.6%
Gold, cash - H&H	287.1	-13.6%	-22.2%
W Tx Int Cr Oil	17.80	-15.8%	-31.4%
CRB Futures Ind	229.1	-5.7%	-4.4%
CRB Raw Indust	307.5	-8.7%	-8.2%

Money			
M2, Bil Curr$, Nov	3941	1.5%	5.3%
Free Reserves	691	71.2%	-11.4%
Money Mkts - Bil$	1028	4.9%	18.1%

Industry			
Indust Prod Ind, Nov	127.3	1.7%	5.6%
NAPM Ind, Dec	52.5	-1.7	-1.3
Cap Util, Nov - %	83.2	0.4	0.9

Economy			
GDP-Bil$, 3rd Qtr	7214.0	3.0% apr	3.9%
Unemplmnt %, Nov	4.6	-0.3	-0.7
Leading Indic, Nov	104.6	0.5%	1.9%

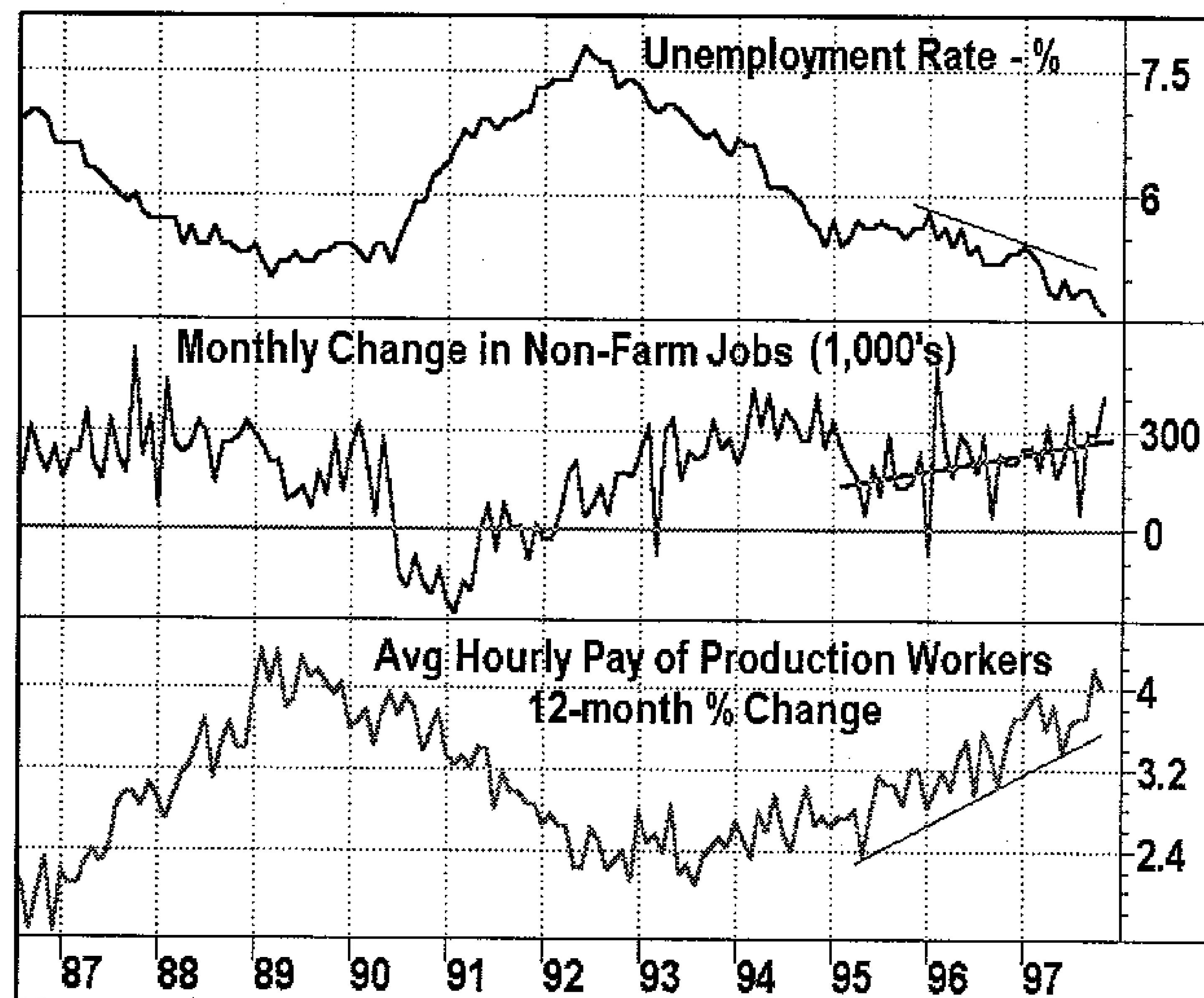
The stock index table above shows how the stock market surged higher over the past 12 months, but slowed in the last quarter. The S&P500, the NYSE Composite Index and the Wilshire 5000 are all up about 30% for the year. The NASDAQ has pulled back over the past 3 months by 6.8%, which brought the 12-month performance figure down below that of the broader stock indices. The S&P500 Index outperformed the Dow Industrials by virtue of greater strength early in 1997. Short interest rates have risen while long rates have fallen over 3 and 12 months. Short interest rates have been held high by the Federal Reserve as preventative medicine against inflation. However, the decline in long interest rates comes as no surprise, considering the extraordinarily low rates of inflation shown in the table above at right. Gold and oil prices have dropped far more than 20% in the past 12 months, while industry is vigorous and unemployment is at a 26-year low. The economy as a whole is showing robust growth, with GDP up 3.9% for the year. This particular combination of very low inflation with rapid economic growth and a tight labor market has rarely been seen in the past, and this has been a very important contributing factor to the stock market's gains over the past few years.



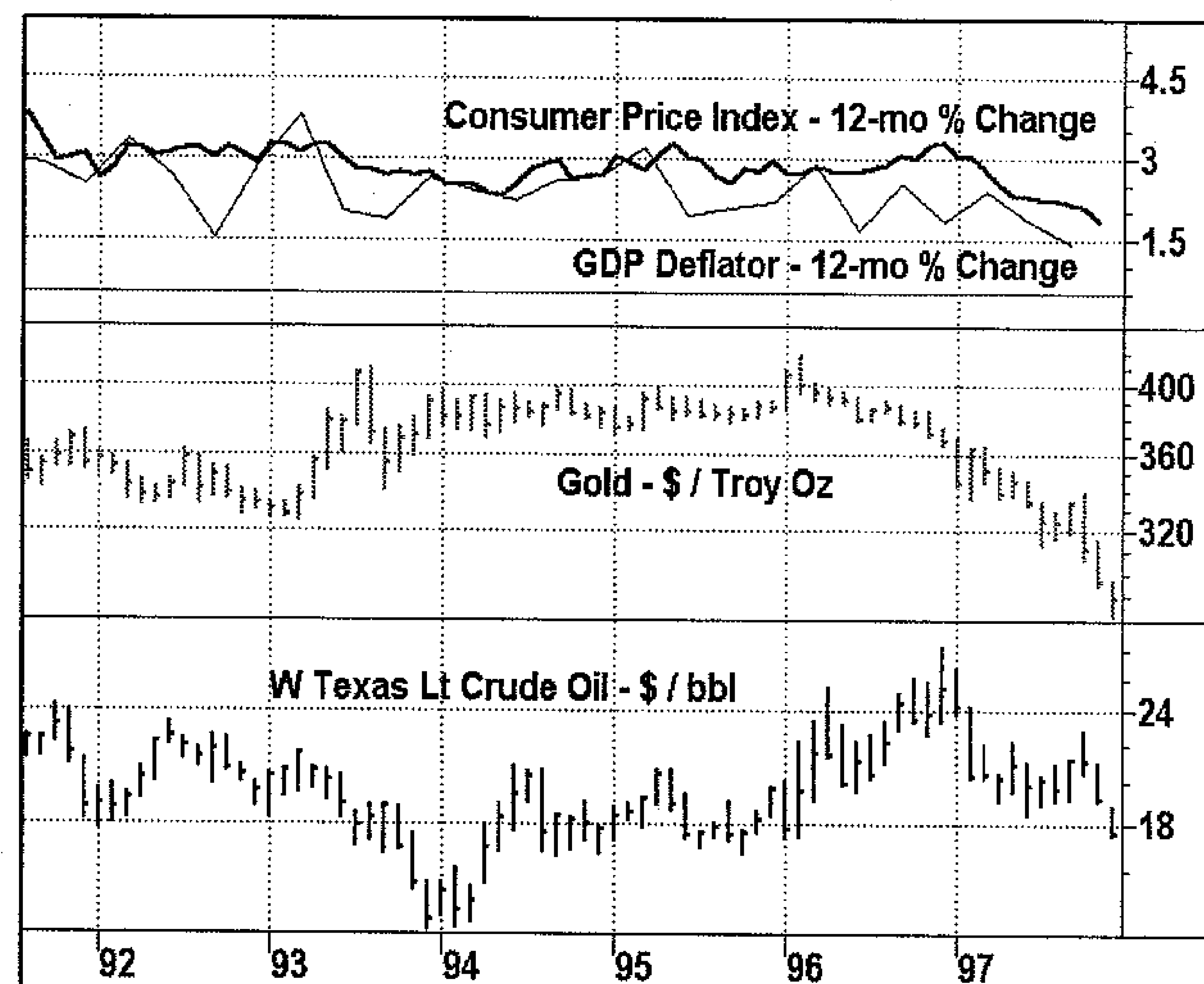
MANUFACTURING The manufacturing sector of our economy has been operating at a rate not often seen during the past decade and some evidence has appeared that the rate has begun to slow. The Industrial Production Index has increased by 5.6% over 12 months through November, and the rate of increase has been climbing. This is a rate of growth exceeded during only a small portion of the time since 1985. The North American Purchasing Managers Index stood at 54.4 in November, and fell to 52.5 in December, continuing the sharp reversal that began after mid-year. These 2 indicators have diverged recently, as the trend of the Industrial Production Index rate of change is clearly up, while the NAPM Index shows a pronounced downward break on the chart. The most recent data comes from the NAPM Index and the slowing in the rate of industrial growth will most likely be confirmed by the Industrial Production Index when that data comes out later in January. The capacity utilization of industry was 83.2% in November, also one of the highest levels in over a dozen years. The increases in capacity utilization have been smaller than those in the Industrial Production and NAPM Indices. Capacity has been added over the past few years that has helped prevent problems of bottlenecks that could have slowed production and resulted in price increases. Durable goods orders took a 4.8% jump in December, propelled by orders for aircraft. While this was the biggest monthly increase in 5 years, without the transportation component the monthly change was a minus 0.2%. For each of the 3 months ending in November, housing starts reached over 1.5 million/month, a pace that hasn't been seen since 1988. Falling mortgage interest rates are helping this industry a great deal.

SALES Growth in retail sales dollars has continued at a steady rate of about 5% per year over the past 2 years. Retail sales were not particularly strong during the first part of the holiday season, but seem to have picked up toward the end. As retail sales to consumers are responsible for about 2/3 of our economy and a generous portion of the year's sales occurs during the holiday season, performance during this period is extremely important. Sales of new single family homes have been rising for the past 3 years and seem to have reached a plateau at a rate of about 800,000 per month. Auto and light truck sales have continued within a range of 15 to 16 million units per month for the past 4 years. Thus, the level of sales activity in general has been very stable.

LABOR The labor market in the U.S. has become extremely tight. Starting from a high of 7.8% in June of 1992, the unemployment rate has gradually and steadily fallen to its current level of 4.6%, which is the lowest since October of 1973. To find a rate any lower, one must look back still further to March of 1970. The growth in jobs, middle chart at right, partially explains how the rate has fallen so low. The heavy line drawn through the trend of the change in non-farm jobs shows the monthly number of jobs created starting at about 150,000 per month in early 1995, and rising to nearly 300,000 at the end of this year. This essentially means that the rate of job creation today is twice that of 3 years ago. This abundance of jobs promotes a widespread sense of security which helped boost the Conference Board's Consumer Confidence Index rise to 134.5, the highest level since 1969. Confirming the tightness of the labor market, the monthly average of overtime hours worked per week in manufacturing reached 4.9 in November, equal to the highest since 1956, the limit of my records. The bottom chart showing the increase in hourly wages appears to have tilted upward as this expansion of jobs began in 1995. The 12-month rate of increase in November was 4%, which is not yet problematic for inflation. The upward trend has been fairly steep and steady since 1995, and it is this trend that has many economists worried about the future prospects for inflation. Wages are said to be responsible for 2/3 of inflation, so this threat definitely bears watching. Fortunately, increased efficiency has so far managed to make up for the increases in wages. The index of labor cost per unit in manufacturing stood at 99.1 in October, the last month measured. A figure of 100 for this index equals the average for the year 1992, so it is apparent that labor costs as a portion of production costs in general have remained very stable.



INFLATION The rate of inflation in our economy is extremely low. Measured by the 12-month change in the Consumer Price Index, it fell to 1.8% in November. Measured by the GDP Deflator in the 3rd quarter, it fell to 1.4% over 12 months. The rate indicated by the CPI is the lowest in 10 years. Other than during a brief period in 1986 and 1987, the inflation rate has not been this low since the mid-1960's. The price of gold has plummeted from over $400/oz. at the beginning of 1996 to well below $300/oz. today. The Producer Price Index of wholesale prices has actually declined by 0.6% over 12 months. Raw materials prices are generally in a steep decline because of economic weakness resulting from financial problems in Asia. Copper prices have dropped more than 30% since last June. Likewise, the price of oil has fallen below $18/bbl, lower than it has been in nearly 2 years. No other commodity price can match the price of oil in terms of the impact on the world's economy, so this means diminished inflationary pressures around the world. The steepest of these widespread price declines has taken place in the past month and therefore it has not yet had a chance to register on the Producer Price Index. When this happens in the next month, the inflation rates at the wholesale and consumer levels will fall still further and faster. Nevertheless, looking farther into the future, this widespread, precipitous decline cannot last forever. The rebound in prices, when it inevitably comes in 6 months or in a year or more will most likely have an adverse effect on inflation and upon interest rates as well.



SUMMARY AND OUTLOOK An unusual set of conditions prevails in our economy today: rapid growth, a very tight labor market and a very low rate of inflation. This is unusual because rapid economic growth and a tight labor market tend to be inflationary in nature. The diminishing of inflation in spite of conditions that have been historically closely connected with higher inflation is a surprise to many economists and not well understood. Inflation has been kept at bay partly because of worldwide competition and cheap labor elsewhere. In addition, the high-tech revolution has borne fruit in increased efficiency that has been difficult to measure. This greater efficiency has had a pronounced deflationary effect. Further, the world economy has not been particularly strong, so commodity prices have remained relatively stable up to the point of the recent steep decline. Because of the financial and economic problems in Asia, the outlook is for stable to still lower rates of inflation. The slight slowing of our economy caused by a worldwide slowdown should reduce the tightness of the labor market. GDP growth, which hit nearly 4% in 1997, should slow to 2% to 2.5% next year, precisely the range that the Fed regards as healthy and sustainable. The effects of the slowdown on our economy and corporate earnings will be cushioned by the benefits of cheaper raw materials and lower interest rates.

Interest rates will be further lowered by the fact that our government will almost certainly run a surplus instead of a deficit for the first time in nearly 30 years. This will be helped by a boost in tax receipts of over $100 billion coming from capital gains taxes on stock option and mutual fund transactions. The capitalization of the U.S. stock market has risen to 115% of GDP, compared to a 60-year average of 48%. Rather than being an indication of high valuation, this is a result of U.S. participation in the growing global economy.