THE COMPASS

A QUARTERLY NEWSLETTER FROM MARTIN CAPITAL MANAGEMENT

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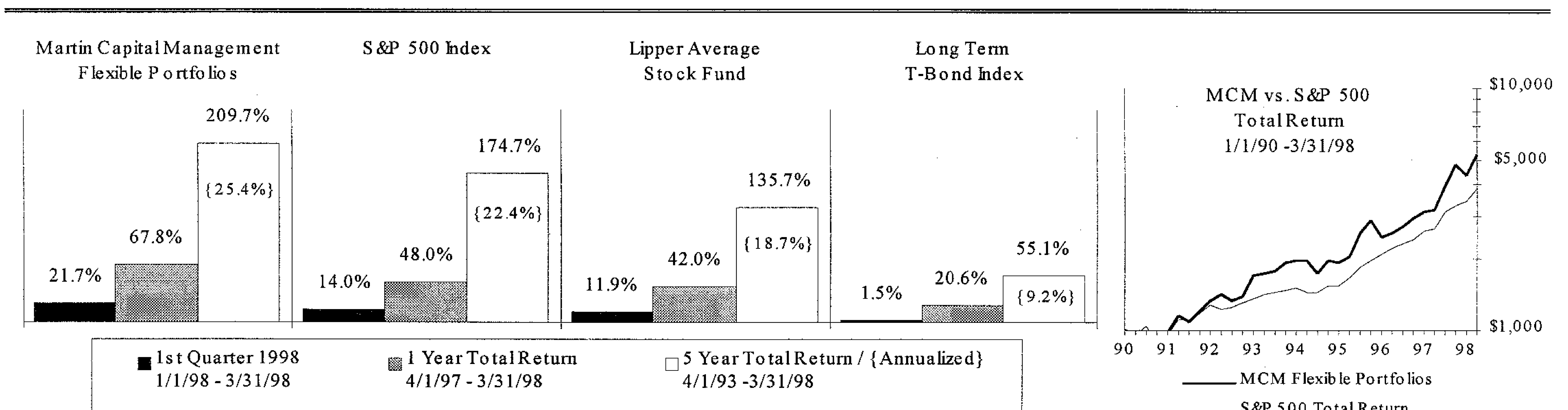
April 1, 1998

DJIA 8799.81 / S&P 500 1101.75 / NASDAQ Comp. 1835.68 / Wilshire 5000 10494.72
J.P. Morgan Dollar Index 111.3 / Long T-bond Index 7760.82 (5.99% Yield)

Investment Results



Investment Perspective

The stock market began the first quarter with a continuation of the fourth quarter's poor performance, but began to rally back during the last half of January. As anticipated in *The Compass* at the beginning of the year, the rally was sustained through the end of the quarter by the realization that corporate earnings were not going to be as negatively impacted by Asia's economic woes as previously feared. Bonds put in a mediocre performance for the quarter – getting off to a good start at the beginning of the quarter, but giving back a little more than expected at the end of the quarter.

The stock market may be buffeted by cross winds during the second quarter. On one side many stocks are over-valued; on the other side there are still many stocks, especially in the high tech sector, that are attractively priced. While real interest rates have been quite high for some time, tight labor markets could cause inflation to bounce back enough to spook the bond markets, but the current weakness of the Asian economies could temper economic growth enough to keep inflation in check. If interest rates come down fast enough, they could offset a slowdown in corporate profits. If real rates remain too high and the Asian economies weaken further, then corporate profits could fall enough to set off a short bear market. Our guess is that the first part of the second quarter may see the stock market continue to move to the upside. The end of the quarter may find us back to square one – a mixed market with the index averages around where they are today. Bonds may do slightly better than stocks by the end of the quarter, perhaps breaking below 5.5% on the long T-Bond.

For the long haul, we remain extremely bullish on the prospects for the U.S. financial markets. The bullish triad of the global economy, high technology productivity and U.S. "baby-boom" demographics will continue to be the predominate forces in the unfolding of the secular bull market. Any short-term correction should be followed by further gains later in the year. Accordingly, we are remaining fully invested for established clients, and will gradually allocate any cash positions into stocks for new clients over the course of the next three to six months.

Despite our poor performance at the end of last year, Nelson's *World's Best Money Managers* (http://www.nelnet.com) continues to rate Martin Capital Management #1 in U.S. Tactical Asset Allocation for several time periods through December 31, 1997. Given our excellent first quarter performance, there is a fair chance that when Nelson's reports performance numbers through the end of the first quarter of 1998 we may gain back some of our #1 ratings in the U.S. Balanced/Multi-Asset class as well.

Market Timing Viewpoint

Recommended Tactical Asset Allocation

Stocks 80% (Δ -5%) Bonds 15% (Δ unch) Cash 5% (Δ +5%)

Performance Expectation

	June 30, 1998		December 31, 1998		December 31, 2002	
	Target	% Change	Target	% Change	Target	% Change
DJIA/S&P 500	8800/1100	+00.0%	9700/1200	+10.0%	17600/2200	+100.0%
Nasdaq	1925	+ 5.0%	2100	+15.0%	4800	+130.0%
T-Bond Index	5.75%	+ 5.0%	5.50%	+10.0%	4.50%	+ 25.0%

20 Largest Common Stock Positions

(Prices as of March 31, 1998)

1 Dell Computer	67.75	6 Applied Materials	35.31	11 Southwest Airlines	29.56	16 Oracle	31.56
2 Charles Schwab	38.00	7 Cisco Systems	68.38	12 Home Depot	67.63	17 Advanced Micro Dev	29.06
3 Whole Foods Mkt	69.75	8 Texas Instruments	54.13	13 Electronic Arts	46.94	18 Travelers	60.00
4 Microsoft	89.50	9 Williams-Sonoma	57.88	14 Computer Associates	57.75	19 Motorola	60.75
5 Intel	78.06	10 Hewlett-Packard	63.38	15 CompUSA	26.13	20 Tiffany	48.69

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%
1998 YTD	+ 21.7%	+ 11.7%	+ 14.0%	+ 13.3%	+ 1.5%	+ 1.3%	+ 0.4%
Total**	+437.3%	+312.3%	+290.7%	+275.2%	+125.0%	+ 44.5%	+ 28.7%
Avg.***	+ 22.6%	+ 18.7%	+ 18.0%	+ 17.4%	+ 10.3%	+ 4.6%	+ 3.1%

* 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 – 1998 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 for individuals, trusts, and pension plans.

MARTIN CAPITAL MANAGEMENT
QUARTERLY ECONOMIC REVIEW

by Alston Boyd, Economic Director

Market and Economic Statistics as of Market Close on March 31, 1998, with 3-month & 12-month Changes

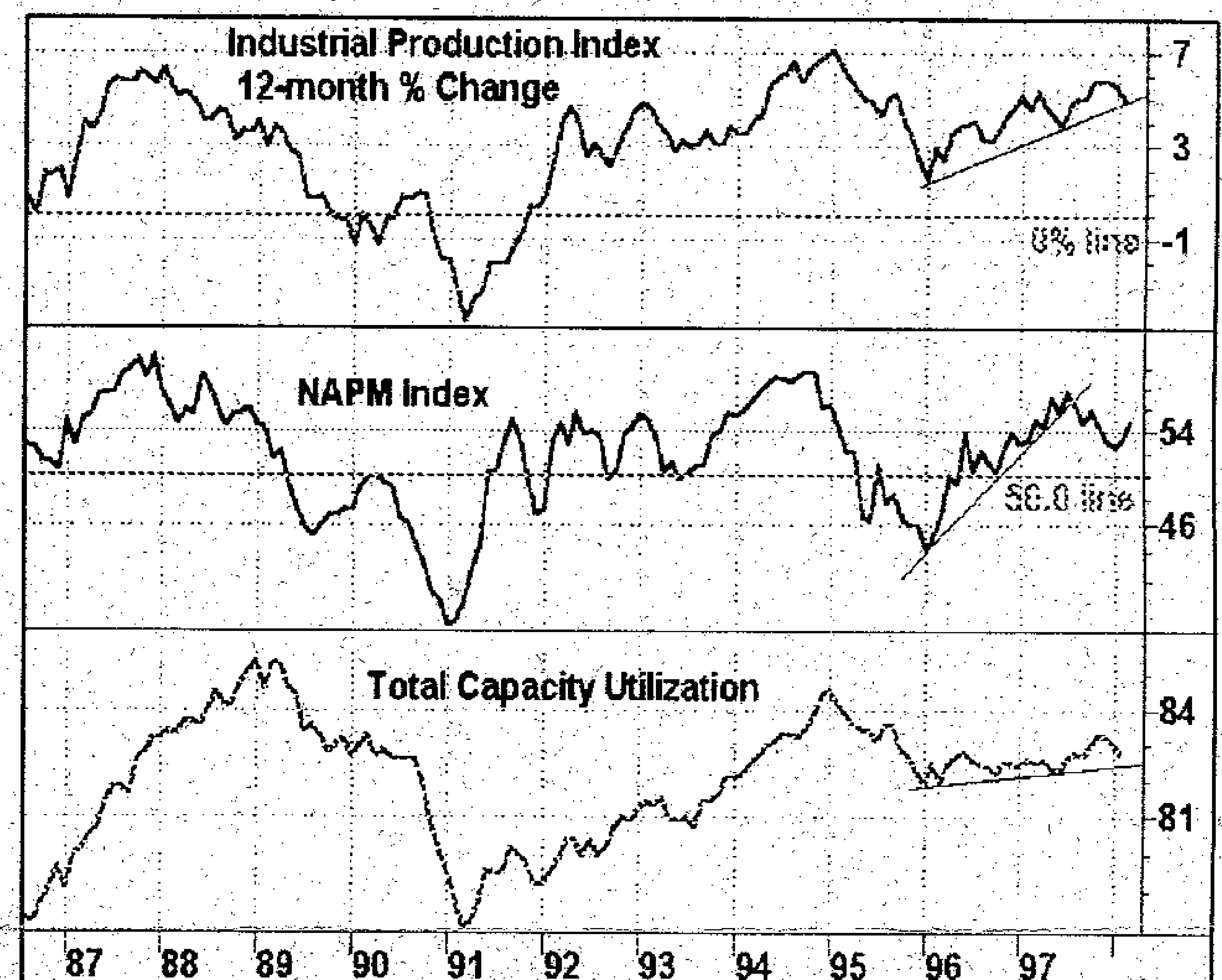
Stock Indexes*		3 mo	12 mo	Interest Rates		3 mo	12 mo	Prices, Inflation		3 mo	12 mo
Dow Industrials	8800	11.3%	33.7%	91-day T-Bill DR	5.00%	-4.0%	-4.0%	CPI, Feb	161.9	1.1% apr	1.5%
S&P 500	1102	13.5%	45.5%	30-yr T-Bond Yld	5.95%	0.5%	-16.1%	PPI, Feb	130.1	-5.2% apr	-1.6%
NYSE Comp Ind	573	12.0%	43.7%	FNMA 30yr mortg	7.07%	-1.5%	-14.9%	Gold, cash - H&H	301.0	4.9%	-13.8%
NASDAQ	1836	16.9%	50.3%	Prime Rate	8.50%	0.0%	0.0%	W Tx Int Cr Oil	15.85	-11.0%	-22.5%
Wilshire 5000	10495	12.9%	45.5%	Fed Funds Trgt	5.50%	0.0%	0.0%	CRB Futures Ind	228.9	-0.1%	-6.6%
Russell 2000	481	10.0%	40.3%	Fed Disc Rate	5.00%	0.0%	0.0%	CRB Raw Indust	300.5	-2.3%	-11.2%

* excluding dividends

Money				Industry				Economy			
M2, Bil Curr$, Feb	4096	2.0%	6.3%	Indust Prod Ind, Feb	128.1	0.5%	4.9%	GDP-Bil$, 4th Qtr	7280.0	3.7% apr	3.7%
Free Reserves	1225	3.6%	47.6%	NAPM Ind, Mar	54.8	1.7	-0.2	Unemplmnt %, Mar	4.7	0.0	-0.5
Money Mkts - Bil$	1139	6.8%	19.2%	Cap Util, Feb - %	82.7	-0.6	0.1	Leading Indic, Feb	105.0	1.9% apr	1.6%

The table above shows the astonishing stock market performance of the past 12 months. This big rise has been made possible by exceptionally good economic conditions, some of which are illustrated above: falling long interest rates, stability in short rates, and strong economic growth under conditions of low inflation. The M2 measure of the money supply shows an expansion in 12 months of over 6%, another factor historically helpful to the stock market. No signs of any dramatic changes in these conditions have appeared on the horizon other than the Asian problems, so there is no reason to expect any sudden reversal.

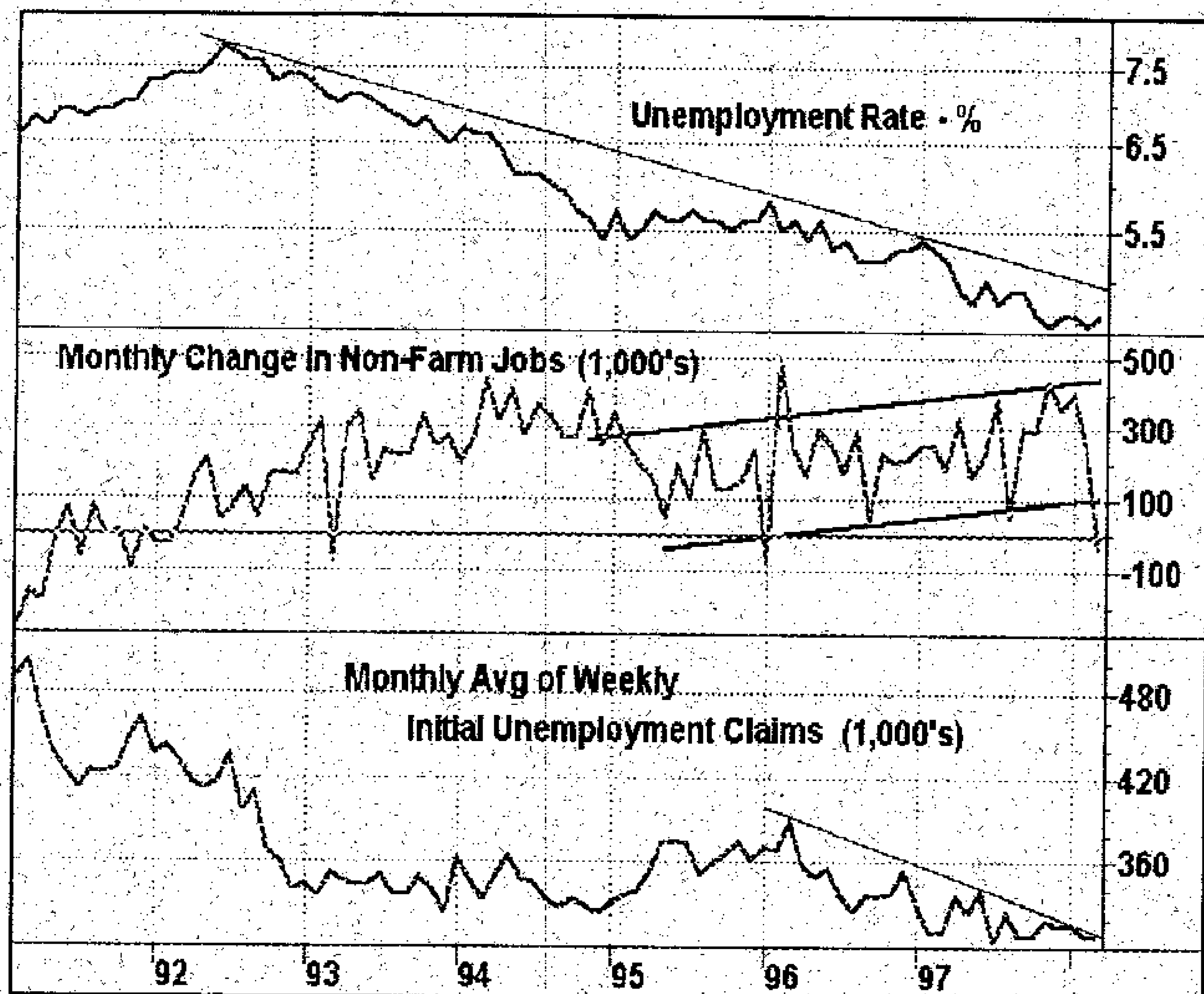
MANUFACTURING We continue to see very healthy growth in the manufacturing sector of our economy. The North American Purchasing Managers Index rose to 54.8 in March, a level exceeded during only about 10% of the past decade. This latest figure represents an upturn from the trend of the previous 3 months and perhaps a resumption of the even more rapid growth experienced during the middle of 1997. The 12-month change in the Industrial Production Index through February has stayed on the upward trend it has followed since the beginning of 1996. The "Asian contagion", the fallout from the drastic economic problems being experienced in the Far East, has so far not had a big effect on our manufacturing sector.



Both commercial and residential construction have been experiencing rapid growth. Mortgage rates are down near 7%, the lowest in over 20 years and are a major factor driving what can only be described as a boom. Strong demand exists for office and other commercial space after a long period of relatively little construction. Consumers are feeling very secure, the result of a tight job market, rising wages and a strong economy. While unseasonably good weather around the country helped construction continue through the winter months at an abnormally high level (blame El Niño!), there is no doubt, however, that a real construction boom is under way. Without weakness in the job market or higher interest rates, neither of which seem likely, this boom should continue.

SALES Growth in the dollar volume of retail sales over 12 months was only 2.4% in February, the smallest such increase in over 2 years. Auto sales have been relatively steady, ranging between 15 and 16 million units sold per month over the past 2 years. The real action is in new home sales, which are experiencing a boom. The figure of 893,000 homes sold in February was an all-time record. Consumers are feeling secure, as shown by the very high Consumer Confidence Index, and are willing to step up to the biggest purchases many will make in a lifetime. The low unemployment rate combined with higher paychecks across the country has given consumers the sense of security that allows them to make these big financial commitments. Added to the secure financial and economic conditions for consumers are mortgage rates that have fallen into the 7% range, making housing more affordable.

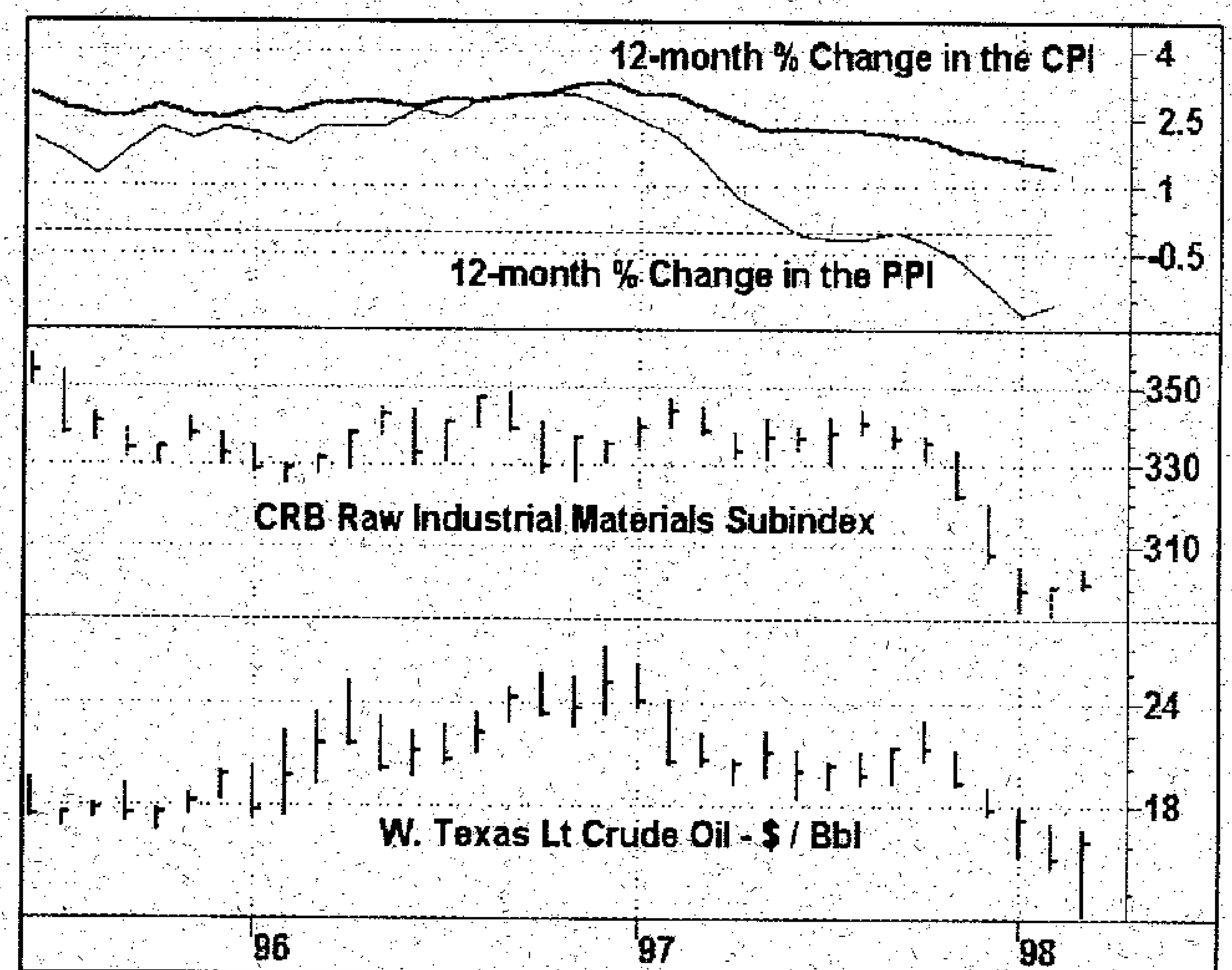
LABOR The U.S. labor market continues to be tight, with 4.7% unemployment (see charts on next page) and fewer workers losing their jobs (as indicated by initial unemployment claims). The figure for the number of new jobs in the month of March was a surprise because it actually declined by 36,000 in spite of a strong economy. Weather and seasonal factors were at work here. Weather was the cause the last time the monthly number of new jobs fell below zero in January 1996, when a blizzard paralyzed the northeastern U.S. This time, mild winter weather allowed construction to continue during a time of the year when it normally can't



proceed because of cold and snow. The job figures for December, January and February were inflated because many workers were never laid off. Then, when the normal time to hire came in March, the seasonal adjustments showed a big shortfall in hiring because many of these people were already working and, added to that, the weather was bad. Blame El Niño again! The bottom chart shows that the number of initial unemployment claims did not rise at the same time, indicating that no widespread job termination took place and therefore that no sudden softness appeared in the job market.

New jobs are being created in our economy at a rate of about 3.5 million a year while at the same time the pool of available workers is growing smaller. This combination is a prescription for wage inflation. The Employment Cost Index rose sharply at the end of 1997, up 3.2% over 12 months. While still a relatively low number, this rate of increase is most remarkable for the sharp upward turn it took in the last half of 1997. Counteracting this wage pressure is the deflation taking place in some places in Asia, where currency devaluations have effectively dropped wages measured in U.S dollars by over 50%. Many jobs have been exported over the past decade and this trend will accelerate, pushed by the increasing differential of higher wages here and lower wages elsewhere. Already, software for U.S. companies is being written in countries such as India and sent to the U.S by satellite links. This kind of innovation will expand other technologies and countries. Nevertheless, many jobs in this country require the worker's physical presence. Most new jobs here, however, are being created in the service sector and cannot be performed by people living overseas. Likewise, the construction industry is presently expanding and most of those jobs require workers' physical presence here. These factors point to the job market growing tighter over the next few months.

INFLATION The overall inflation rate has continued to decline, pulled down by falling commodity prices, especially those of oil and raw industrial materials. The 12-month increase in the Consumer Price Index rose only 1.4% through February, while the wholesale Producer Price Index fell by 1.6% in the same period. Oil and raw materials prices have been dramatically affected by the Asian economic crisis because the demand from manufacturers there has fallen through the floor. The pressure on prices will extend to products coming from Asia as well as raw materials. For instance, capacity exists in Japan to produce about 15 million automobiles, while sales of cars in Japan during 1998 are anticipated to be less than 5 million. Similar overcapacity is present in Korea and other Asian countries. Exports will be crucial to those countries and prices will come down as competition heats up. American consumers will benefit from these lower prices in at least 2 ways: first, they can buy more and better products and second, the rate of inflation here will be held down by the lower prices.



As the Japanese fiscal year ended March 31st some unsettling facts came to light. Japanese business sentiment is at a 20-year low, spending at a 28-year low, the economy is stagnant and corporate profits are expected to fall. Moody's Investment Service issued a warning about Japanese government debt. The Chairman of the Sony Corporation stated publicly that the Japanese economy was in danger of collapse. As Japan has the world's second largest economy, economic collapse there would have a big effect on the rest of the world. If their economy should implode, the deflationary effects will be felt around the world. We have little or no control over what will happen there and it is difficult to anticipate what the final outcome will be.

SUMMARY AND OUTLOOK Here in the U.S., we are caught between 2 strong, opposing sets of forces. Our tight labor market and steadily increasing wages will push toward inflation. The construction industry makes up about 20% of our GDP, so a boom in that labor-intensive industry must have an inflationary effect. We have benefited from the deflationary forces we have experienced so far, but we will not experience another wave of falling commodity prices as strong as the one we have already seen. Falling prices of Asian products will continue to have the effect of holding down prices, however. The result of these competing forces is as yet unknown and will be determined largely by factors overseas that we cannot measure. At this moment, the deflationary forces seem to be waning slightly, but if the Japanese economy becomes much weaker, deflationary forces will have the upper hand.

GDP growth for the 1st quarter has been strong, perhaps at an annual rate of 3% to 3.5%, and a construction boom is presently overcoming any slowing resulting from Asian problems. Strong growth should continue into the next quarter, provided conditions in Japan and the rest of Asia don't substantially worsen. The Fed will need to hold interest rates where they are because of the Asian problems, as any interest rate hike here in the U.S. would make the currency exchange rates even worse for Asian countries.