THE COMPASS

A QUARTERLY NEWSLETTER FROM MARTIN CAPITAL MANAGEMENT

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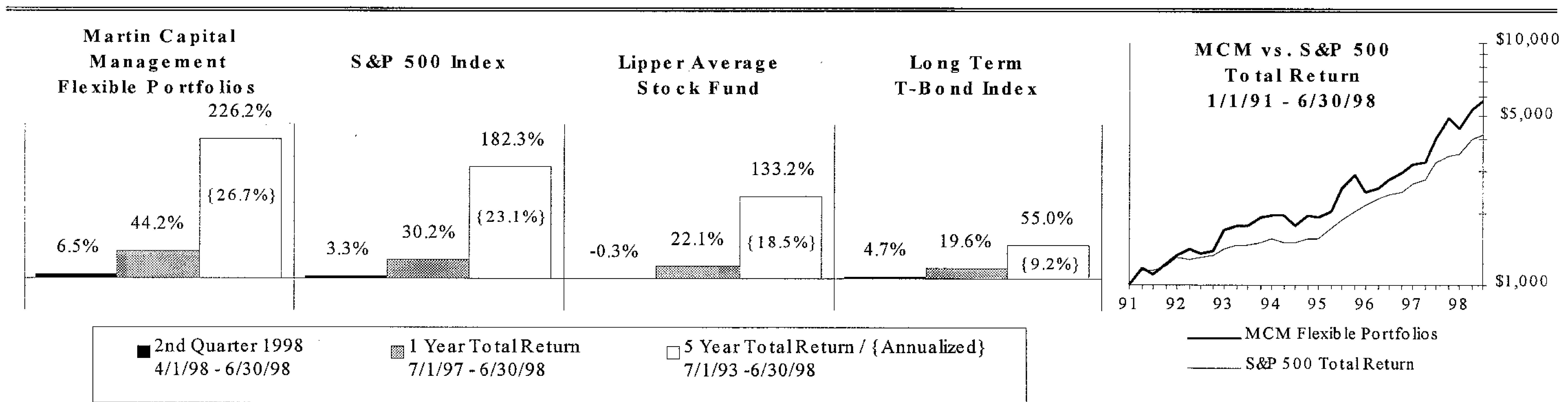
July 1, 1998

Investment Results



MCM Flexible Portfolio 12 Month Tax Efficiency: 98.8% (After Tax Return divided by Before Tax Return)

Investment Perspective

The financial markets performed pretty much in line with our expectations during the second quarter. As predicted at the beginning of April, stock market indices advanced during the first part of the quarter, but gave back most of their gains by the end of the quarter. Interest rates fell to within the range of our target of between 5.50% and 5.75%, resulting in bonds achieving the "slightly better than stocks" performance anticipated in the April newsletter.

The main question for the third quarter is how much further will corporate profits and economic activity decline. The most likely scenario will be for the economy to slow somewhat further and for corporate profits to remain under pressure at least through the first part of the quarter. By the end of the quarter the economy should begin to find its footing and corporate profits should begin to stabilize. Though the economy may eventually rebound without a specific stimulus, there is a fair chance that the Federal Reserve Board may lower rates sometime during the next few months. There is also a possibility that the Asian economies may start to show signs of improvement in the near future, bolstering the prospects for the U.S. economy. Once the stock market senses an impending pickup in corporate profits the stage will be set for a significant rally. As long as the economy continues to weaken, interest rates will continue to decline. As the economy recovers, interest rates may rise to slightly higher levels. For the time being we will maintain fixed income positions and add to equity positions over the next few months.

Nelson's *World's Best Money Managers* (http://www.nelnet.com) again has rated Martin Capital Management #1 in U.S. Tactical Asset Allocation and U.S. Balanced/Multi-Asset classes for almost all periods up through five years ending March 31, 1998. When the numbers through the end of June are reported most of the #1 ratings should be sustained. It also should be noted that Jeff D. Heard, Jr., P.C., Certified Public Accountants, has recently verified our performance numbers for 1991 through 1997. A copy of their report is available on request.

Market Timing Viewpoint

Recommended Tactical Asset Allocation

Stocks 90% (Δ +5%) Bonds 10% (Δ -5%) Cash 0% (Δ -5%)

Performance Expectation

	September 30, 1998		June 30, 1999		June 30, 2003	
	Target	% Change	Target	% Change	Target	% Change
DJIA/S&P 500	9400/1200	+ 05.0%	10300/1300	+15.0%	20100/2500	+125.0%
Nasdaq	2100	+ 10.0%	2300	+20.0%	4700	+150.0%
30 Year T-Bond	5.50%	+ 02.5%	5.00%	+10.0%	4.50%	+ 20.0%

20 Largest Common Stock Positions

(Prices as of June 30, 1998)

1 Dell Computer	92.81	6 Intel	74.13	11 Southwest Airlines	29.56	16 Travelers	60.63
2 Microsoft	108.38	7 Texas Instruments	58.31	12 Hewlett-Packard	59.88	17 Sprint	70.50
3 Cisco Systems	92.06	8 Williams-Sonoma	31.81	13 Electronic Arts	54.00	18 Tiffany	48.00
4 Charles Schwab	32.63	9 Home Depot	83.06	14 Computer Associates	55.56	19 Motorola	52.56
5 Whole Foods Mkt	60.50	10 Applied Materials	29.50	15 Chrysler	56.38	20 Oracle	24.56

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	+ 33.9%	+ 24.5%	+ 30.6%	+ 34.2%	+ 18.5%	+ 5.2%	+ 3.1%
1992	+ 26.8%	+ 8.0%	+ 7.7%	+ 9.0%	+ 8.0%	+ 3.3%	+ 2.9%
1993	+ 14.5%	+ 18.1%	+ 10.0%	+ 11.3%	+ 17.3%	+ 2.7%	+ 2.7%
1994	- 2.1%	+ 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%	+ 2.5%
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%	+ 1.7%
1998 YTD	+ 29.6%	+ 14.1%	+ 17.7%	+ 15.5%	+ 6.3%	+ 2.5%	+ 0.9%
Total**	+475.2%	+323.3%	+316.5%	+307.8%	+121.4%	+ 38.1%	+ 21.5%
Avg.***	+ 26.3%	+ 21.2%	+ 21.0%	+ 20.6%	+ 11.2%	+ 4.4%	+ 2.6%

* Total Annual Performance, net of commissions, fees, and expenses, of all Martin Capital Management flexible investment portfolios.
Audited 1991 through 1997 by Jeff D. Heard, Jr., P.C., Certified Public Accountants.

** Total compounded return, including reinvestment of dividends and interest.

*** 1991 – 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

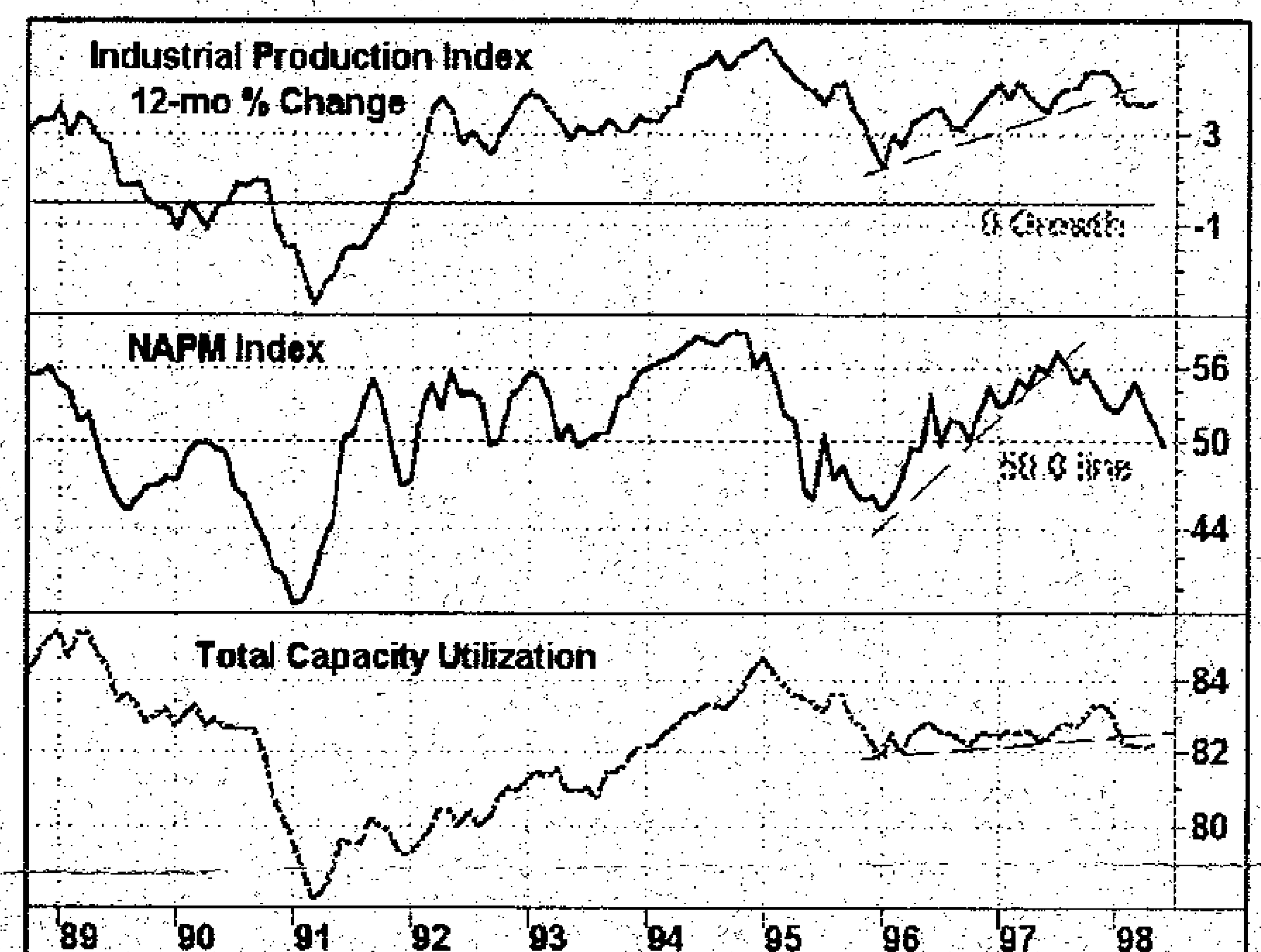
Market and Economic Statistics as of Market Close on June 30, 1998, with 3-month & 12-month Changes

Stock Indexes*		3 mo	12 mo	Interest Rates		3 mo	12 mo	Prices, Inflation		3 mo	12 mo
Dow Industrials	8952	1.7%	16.7%	91-day T-Bill DR	4.96%	-0.8%	-2.7%	CPI, May	162.8	2.2% apr	1.7%
S&P 500	1134	2.9%	28.1%	30-yr T-Bond Yld	5.63%	-5.4%	-17.0%	PPI, May	130.4	0.9% apr	-0.9%
NYSE Comp Ind	579	1.0%	25.1%	FNMA 30yr mortg	7.00%	-1.0%	-9.8%	Gold, cash - H&H	296.3	-1.6%	-11.2%
NASDAQ CI	1895	9.6%	39.7%	Prime Rate	8.50%	0.0%	0.0%	W Tx Int Cr Oil	14.20	-10.4%	-28.1%
NASDAQ 100	1337	3.2%	31.4%	Fed Funds Trgt	5.50%	0.0%	0.0%	Copper. cash	0.73	-7.6%	-35.4%
Wilshire 5000	10664	1.6%	27.0%	Fed Disc Rate	5.00%	0.0%	0.0%	CRB Futures Ind	214.6	-6.2%	-10.4%
Russell 2000	457	-4.8%	15.4%	S/L Long T-Bnd Ind	8124.1	4.7%	19.6%	CRB Raw Indust	294.7	-1.9%	-12.2%

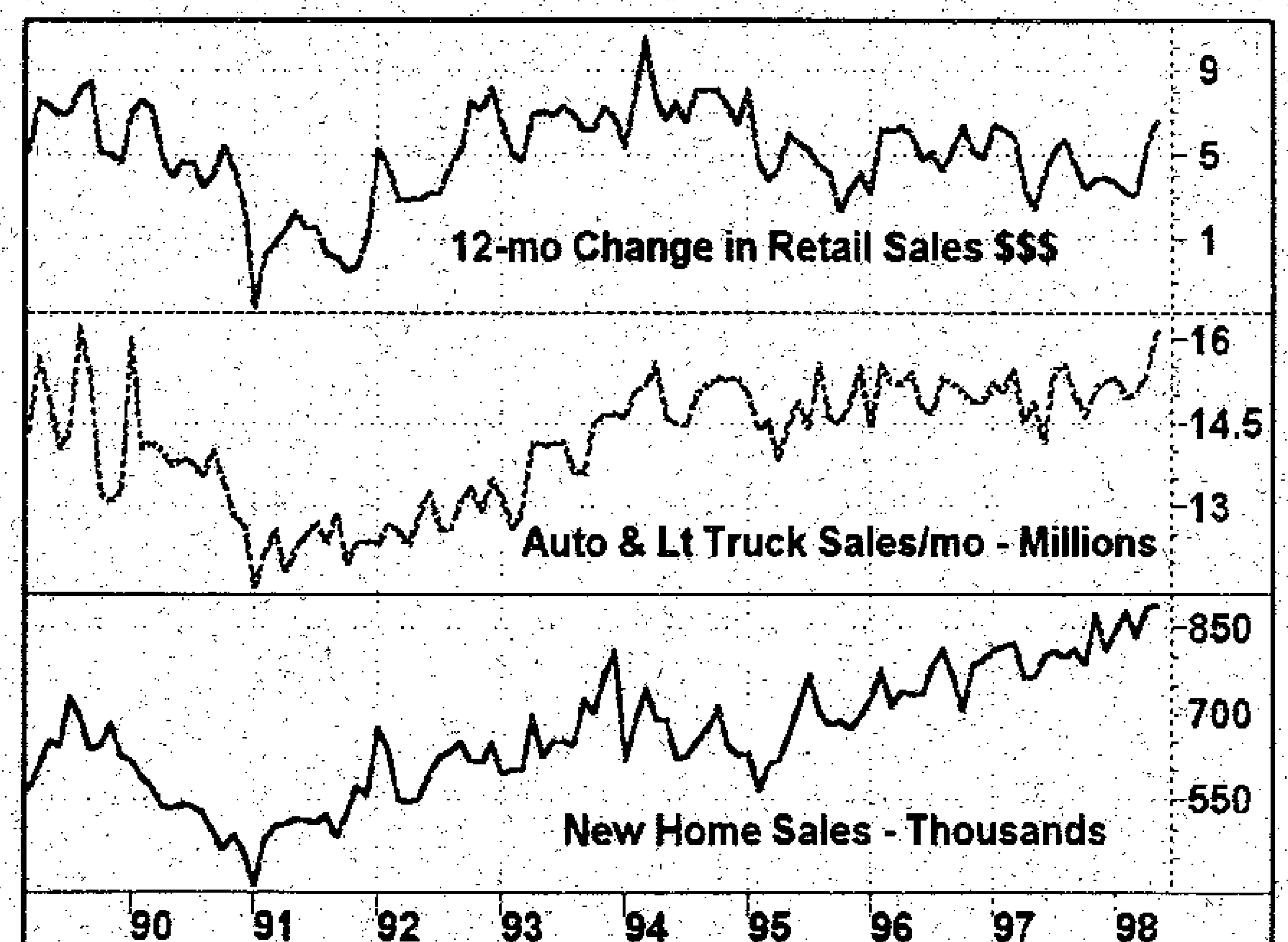
* excluding dividends

Money				Industry				Economy			
M2, Bil Curr$, May	4171	1.7%	7.2%	Indust Prod Ind, May	128.8	1.2%	4.4%	GDP-Bil$, 1st Qtr	7366	4.7% apr	3.7%
Free Reserves	1353	10.4%	29.5%	NAPM Ind, Jun	49.6	-5.2	-6.0	Unemplmnt %, Jun	4.5	-0.3	-0.5
Money Mkts - Bil$	1191	3.5%	23.1%	Cap Util, May - %	82.2	0.0	-0.2	Empl Cst Ind, 1st Qtr	136.1	2.7% apr	3.3%
US $$$ Index	101.17	-0.3%	5.7%	Bldg Permits - May	1545	-4.9%	8.6%	Leading Indic, May	105.2	0.8% apr	1.5%

The stock indices above illustrate how the rapid advance in the stock market over the past year slowed during the last quarter. Short vs. long term rates show a remarkable difference between their amounts of change. Short rates have remained virtually the same, while long interest rates have fallen precipitously. This difference had the effect of drastically flattening the yield curve. Commodity prices have dropped over the past 12 months, as low inflation has prevailed in spite of very low unemployment.

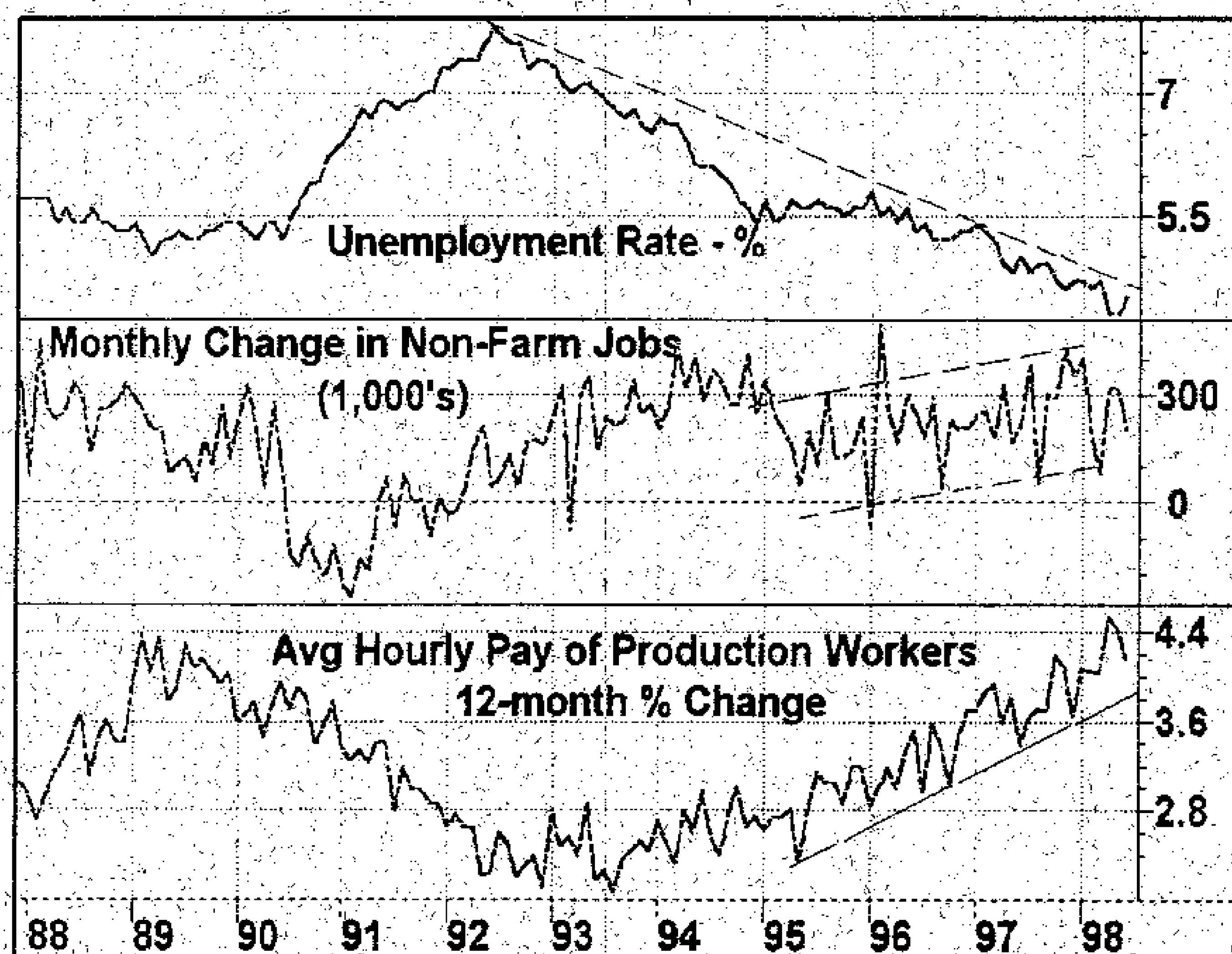


MANUFACTURING The manufacturing sector slowed its rapid rate of growth in contrast to much of the rest of the economy. The 12-month change in the Industrial Production Index has been nearly flat for most of this year with a rate of growth of 4.4%. The North American Purchasing Managers Index declined throughout the last quarter and fell to 49.6 in June, less than the 50.0 reading that separates expansion from contraction. Capacity utilization of industry has fallen to a 2-year low. Part of the contraction in June was due to the UAW strike at General Motors, but most of it resulted from reduced demand for exports as the Asian economic problems have begun to have a clear impact on our U.S. economy. The combination of unfavorable exchange rates combined with a lack of funds to use for purchases has crippled the abilities of Asian countries to afford our products. We are fortunate that the construction industry is responsible for about 20% of our GDP, about twice the portion due to exports. This sector was growing rapidly throughout the quarter and made up for much of the drop in exports.



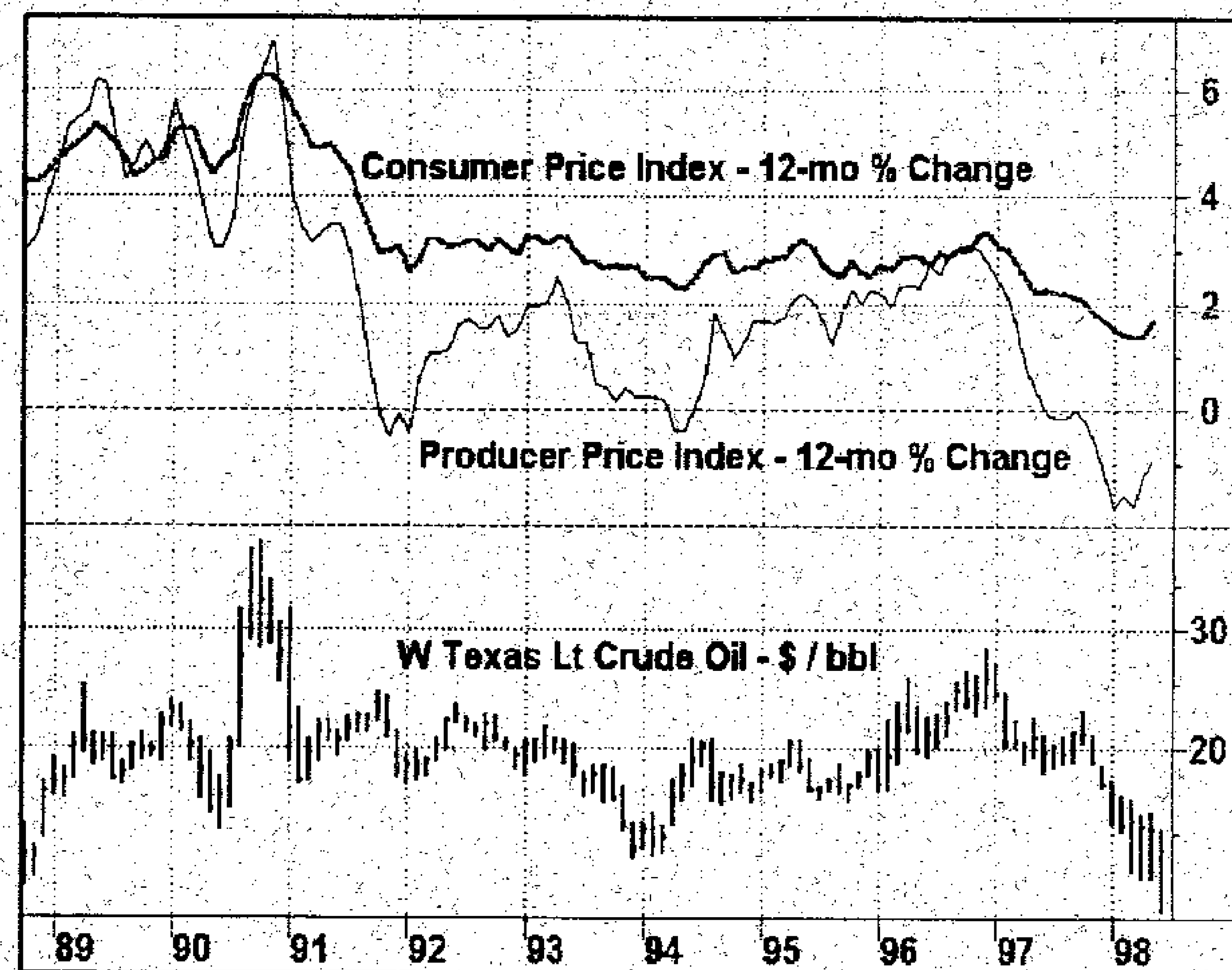
SALES The last quarter was a period of very strong sales activity. The Consumer Confidence Index rose in June to a record high of 137.6, as people have had a high level of comfort in keeping their jobs and the economy as a whole has remained strong. This confidence, together with very low interest rates, has led people in this country to spend their money at or near record rates. Added to these were the incentives of bargain prices on Asian products. The 12-month change in retail sales was up 6.6%, a 2-year high, while auto and light truck sales reached 16.2 million units, the most in 9 years. New home sales hit 890,000, a new record. Low interest rates dropped monthly mortgage payments and allowed many first-time home buyers into the market.

LABOR Our U.S. labor market loosened up a little in June, although the downward trend in the unemployment rate has continued unbroken since 1992. The rise in the unemployment rate from 4.3% to 4.5% was due to the strike at GM, but much was also the result of the overall slowdown in manufacturing. The growth in the number of new jobs each month has been volatile, but has remained within the broad upward trend outlined in the middle chart at right. The recent slump was also



partly due to the strike at GM. The tightness of the labor market has quite naturally led to increases in wages and benefits of workers. Hourly wages of production workers rose 4.2% over the last 12 months, considerably more than the overall inflation rate. Certain specific job categories have seen wages rising as a shortage of workers has occurred. Trucking companies are in effect bidding against each other for long-haul truck drivers. Drivers are jumping from job to job as better and better offers are made to them. Shortages of workers in certain areas of the computer industry are also common. Some jobs in that industry are being exported, for instance programmers are hired in India on a much lower wage scale, and their products are shipped back to the U.S. by satellite links. As wages rise here in the U.S., we may expect to see more jobs move overseas to take advantage of much lower labor costs elsewhere, particularly to countries in Asia that are in dire economic straits. This issue is part of the reason behind the UAW strike.

INFLATION The rate of overall inflation in our economy remains extremely low by historical standards. The 12-month change in the Consumer Price Index rose only 1.7% in June, slightly above the 1.4% rate of the month before. Wholesale prices indicated by the producer Price Index actually fell by 0.9% over the 12 months ending in June. Leading the decline in commodity prices was oil, which fell to less than $12/barrel at one point in June, a 12-year low. Prices of industrial raw materials have continued to slide because of the softness of economies in Asia. Prices of grains and other agricultural commodities have also fallen, hit from both the supply and demand sides. Supplies of corn and other grains are expected to be abundant this year because of an increase in the number of acres planted and because of excellent growing conditions in the most productive areas. Demand for grain has fallen substantially in Asia, contributing to a decline in corn and wheat prices to less than half their 1996 highs. Rising wages are the only real threat to higher inflation and they are being held back from boosting the overall inflation rate by all the other factors cited above.



The Misery Index is the sum of the inflation and unemployment rates. We find in this country now an unusual combination of extremely low inflation at the same time that we have extraordinarily low unemployment, so the Misery Index is about as low as it can go. Historically, these two rates have been out of phase with each other, with one typically high while the other is low and vice versa. The circumstances that have led to this rare set of conditions have to do with the U.S. becoming more and more a part of the world economy during the past decade. Present conditions in our labor market that would have led to higher inflation in years past have this time been subdued by foreign competition. In addition to low foreign wages, competition on prices for all kinds of products have kept prices low, so we have been able to experience strong growth with low inflation.

SUMMARY AND OUTLOOK We can expect a somewhat slower economy ahead, which will be at least partly the result of the slowdown in Asia. The annualized growth rate of U.S. GDP probably dropped to 2.0 to 2.5% in the 2nd quarter from the frenetic 5.4% rate in the 1st quarter. The faster, then slower growth in the 1st and 2nd quarters was partly due to a buildup of inventories in the 1st which had to be worked off in the 2nd. Some of this buildup was due to the drop in exports to Asia. While only about 10% of our GDP is based on exports, we are nevertheless susceptible to the pricing of products coming from Asia, and those prices have continued to fall. This has helped cut consumers' costs of living, and while they have been able to buy more for less money, it means trouble for companies who make products made here and must compete on the basis of price. While American consumers and many manufacturers using Asian products have been the beneficiaries of cheaper imports from that region, the reverse has been true there. Devaluations of currencies in that region have led to double-digit inflation there because imports cost so much more in local currencies. The fundamental costs of food and fuel have risen as much as 50% in their terms. Most of them see exports as the best way out of their difficulties. We are the target market and the competition is increasingly hot, so prices will continue to fall. The economic drama being played out in Asia will continue to unfold over at least the next 3 to 5 years. In summary, cheaper imports from Asia have so far been beneficial to us in keeping down inflation and creating bargains for consumers. These same cheaper imports will hurt U.S. producers of products that must compete directly or indirectly on the basis of price. In that way, cheaper products from Asia may become too much of a good thing. The extent of this negative aspect will become increasingly important over the next year or so, as the fierce competition filters down to corporate bottom lines in the form of lower earnings.

Long interest rates are to some extent an expectation of the level of economic activity as well as inflation, and they have dropped significantly over the past month. While stiffer competition and rising wages are cutting into corporate profits, the positive side is that consumers with rising wages and job security provide a very solid underpinning to our economy. If our economic growth does slow, as I expect, the Fed will need to lower short rates, as they are at present very high and restrictive to growth in real terms.