THE COMPASS

A QUARTERLY NEWSLETTER FROM MARTIN CAPITAL ADVISORS

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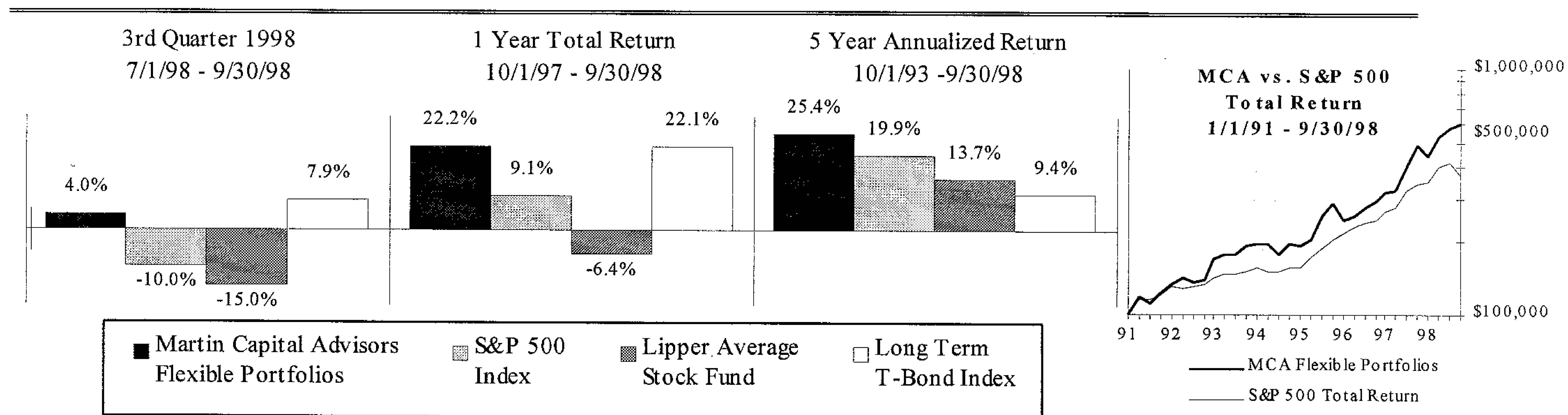
October 1, 1998

Investment Results



MCA Flexible Portfolio 12 Month Tax Efficiency: 95.8% (After Tax Return divided by Before Tax Return)

Investment Perspective

The stock markets' third quarter performance was worse than expected. At the beginning of July we had hoped that by the end of the quarter there would be some sense that corporate profits were beginning to stabilize, allowing the stock market to rebound from anticipated weakness during the first part of the quarter. Unfortunately, the outlook for corporate profits continued to be unclear in the face of further global instability. Selling of stocks was exacerbated by the uncertainty of impeachment proceedings against the President. Concerns about economic weakness contributed to U.S. Treasury Bonds faring much better than our end of quarter target of 5.5%, dropping to just under 5%. As anticipated, the Federal Reserve Board did lower the Fed Funds rate at the end of the quarter.

Higher volatility levels should persist through the first part of the fourth quarter. Any test of the recent stock market lows should hold and set the stage for higher returns by the end of the quarter. The deciding factor for short-term performance will continue to be earnings. If earnings reports come in better than expected and the prognosis for next year begins to improve, the stock market should surge higher. If earnings continue to weaken, stock prices may fall, but the risk/reward ratio will become quite attractive as any further weakness in stocks will begin to discount the possibility of recession. Our guess is that the economy and corporate earnings will not be as negatively affected by the downturn in the global economy as many economists fear. We will be buyers into further stock market selling. For accounts allowing margin, we will consider increasing equity exposure up to 120%. Bonds will probably consolidate recent gains over the next few months. We will consider reducing bond positions if rates move somewhat lower in the short run. For the long-term we remain bullish on the prospects for bonds. U.S. Treasury Bonds could drop below 4% in the next few years as the disinflationary forces of global economic competition, productivity enhancing technological innovation, and favorable U.S. demographic conditions prevail.

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 June 30, 1998. When the numbers through the end of September 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 UNCH)		Cash 0% (Δ UNCH)	
	Performance Expectation					
	December 31, 1998		December 31, 1999		December 31, 2003	
	Target	% Change	Target	% Change	Target	% Change
DJIA/S&P 500	8250/1100	+ 05.0%	9500/1200	+20.0%	20100/2500	+150.0%
Nasdaq	1850	+ 10.0%	2100	+25.0%	4700	+175.0%
30 Year T-Bond	5.25%	- 05.0%	4.50%	+15.0%	4.00%	+ 20.0%

20 Largest Common Stock Positions

(Prices as of September 30, 1998)

1 Dell Computer	65.75	6 Texas Instruments	53.00	11 Hewlett-Packard	52.94	16 Chrysler	47.88
2 Charles Schwab	39.38	7 Whole Foods Mkt	42.13	12 Williams-Sonoma	21.31	17 Sun Microsystems	49.81
3 Microsoft	110.06	8 Home Depot	39.50	13 Electronic Arts	43.88	18 CompUSA	17.31
4 Cisco Systems	61.81	9 Southwest Airlines	20.25	14 Sprint	72.00	19 Computer Associates	37.00
5 Intel	85.75	10 Applied Materials	25.25	15 Oracle	29.13	20 3-Com	30.06

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	+ 29.4%	+ 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	+ 34.7%	+ 0.5%	+ 6.1%	+ 1.6%	+ 14.7%	+ 3.7%	+ 1.2%
Total**	+498.0%	+272.7%	+275.4%	+258.7%	+139.0%	+ 39.7%	+ 21.9%
Avg.***	+ 26.0%	+ 18.5%	+ 18.6%	+ 17.9%	+ 11.9%	+ 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 ADVISORS
QUARTERLY ECONOMIC REVIEW

by Alston Boyd, Economic Director

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

Stock Indexes*		3 mo	12 mo
Dow Industrials	7843	-12.4%	-1.3%
S&P 500	1017	-10.3%	7.4%
NYSE Comp Ind	504	-12.8%	1.5%
NASDAQ CI	1694	0.6%	22.6%
NASDAQ 100	1345	-10.6%	0.5%
Wilshire 5000	9347	-12.3%	1.8%
Russell 2000	364	-20.5%	-19.9%

* excluding dividends

Interest Rates		3 mo	12 mo
91-day T-Bill DR	4.25%	-14.3%	-14.5%
30-yr T-Bond Yld	4.97%	-11.7%	-22.3%
FNMA 30yr mortg	6.48%	-7.4%	-12.4%
Prime Rate	8.25%	-2.9%	-2.9%
Fed Funds Trgt	5.25%	-4.5%	-4.5%
Fed Disc Rate	5.00%	0.0%	0.0%
S/L Long T-Bnd Ind	8769.7	7.9%	22.1%

Prices, Inflation		3 mo	12 mo
CPI, Aug	163.4	1.5% apr	1.6%
PPI, Aug	130.6	0.6% apr	-0.8%
Gold, cash - H&H	296.7	0.1%	-10.7%
W Tx Int Cr Oil	16.13	13.6%	-23.7%
Copper. cash	0.73	0.0%	-24.0%
CRB Futures Ind	203.3	-5.3%	-16.4%
CRB Raw Indust	281.9	-4.4%	-16.3%

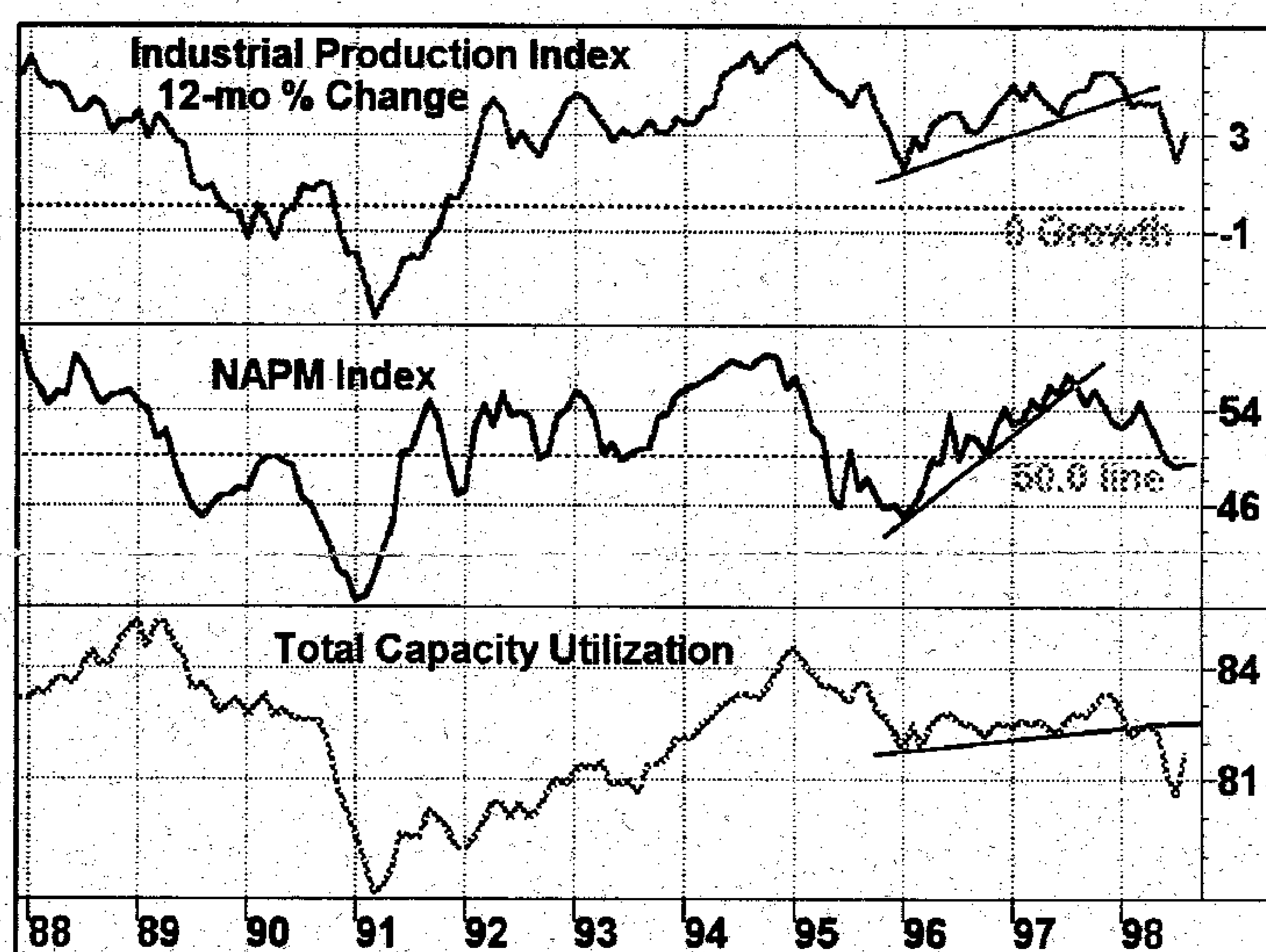
Money			
M2, Bil Curr$, Aug	4237	1.5%	7.1%
Free Reserves	1163	-14.0%	68.3%
Money Mkts - Bil$	1276	7.1%	24.1%
US $$$ Index	96.15	-5.0%	-1.0%

Industry			
Indust Prod Ind, Aug	129.1	0.2%	3.1%
NAPM Ind, Sep	49.4	-0.2	-5.2
Cap Util, Aug - %	81.7	-0.7	-1.1
Bldg Permits - Aug	1616	4.7%	11.8%

Economy			
GDP-Bil$, 2nd Qtr	7499	5.4% apr	4.2%
Unemplmnt %, Sep	4.6	0.1	-0.3
Empl Cst Ind, 1st Qtr	137.3	2.7% apr	3.3%
Leading Indic, Aug	105.5	1.1% apr	1.3%

Most striking of all the numbers in the table above are the differences between the performance of the NASDAQ Composite Index and the Russell 2000 Small Cap Index over the last 3 months and 12 months. Both short and long interest rates subject to market forces have fallen steeply over both time periods. Short rates controlled by the Fed, Prime, Fed Funds target and Discount, have changed very little by comparison, as the Fed has been leaning toward a tight policy rather than loose until very recently. Inflation remains low, with actual deflation occurring in industrial raw materials. Overall, the U.S. economy has remained on an even keel, so far without serious effects from the Asian economic crisis, although economic growth has slowed somewhat. The manufacturing sector with markets abroad has been the hardest hit.

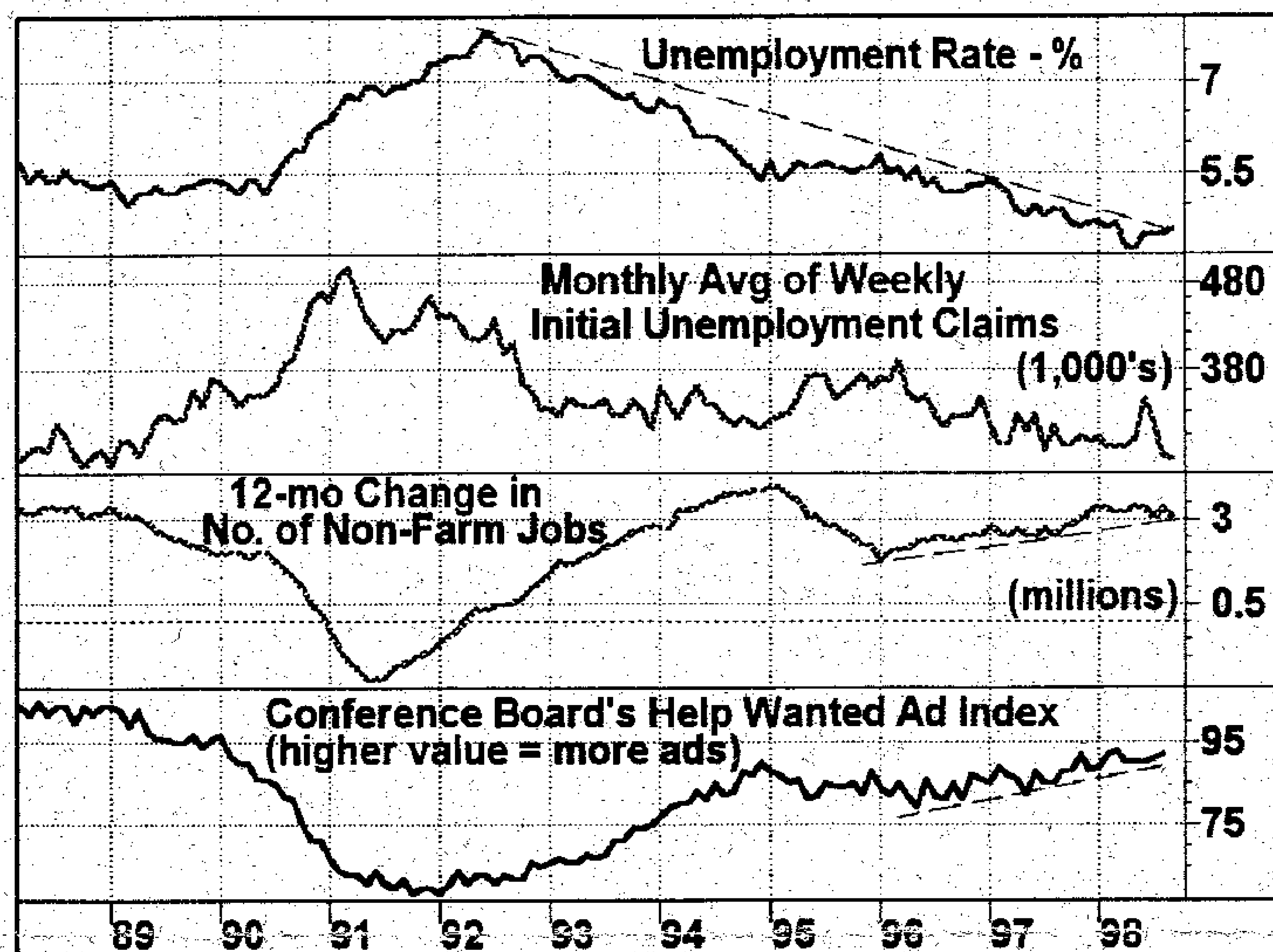
MANUFACTURING After nearly a year of a declining growth rate, the manufacturing sector of our economy appears to have bottomed out. The Industrial Production Index jumped by 1.7% in August, the biggest monthly increase since September of 1983. Part of this jump was due to the end of the UAW strike against GM. The North American Purchasing Managers Index for September came in at 49.4, the same as the previous month and just slightly below the 50.0 value that separates expansion from contraction. This indicator has remained within a narrow range of 2 points for the past 5 months, and thus appears to have stabilized. Total capacity utilization of industry fell to a 6-year low of 80.6% in August, but recovered sharply to 81.7% in September. Factory orders rose by 0.9% in August, helped by the end of the strike in the auto industry, and led by durable goods, which increased by 1.7% in the month. The housing industry remains one of the strongest sectors of our economy. Building permits and housing starts in August were both over an annual rate of 1.6 million, near the highest levels of the past 8 years. This was in spite of housing starts dropping slightly due to hurricane Bonnie, which brought construction to a virtual halt for a short time in the southeastern part of the country. Falling interest rates and high levels of consumer confidence have helped the boom in housing. The decline in rates has accelerated, but consumer confidence is unfortunately waning.



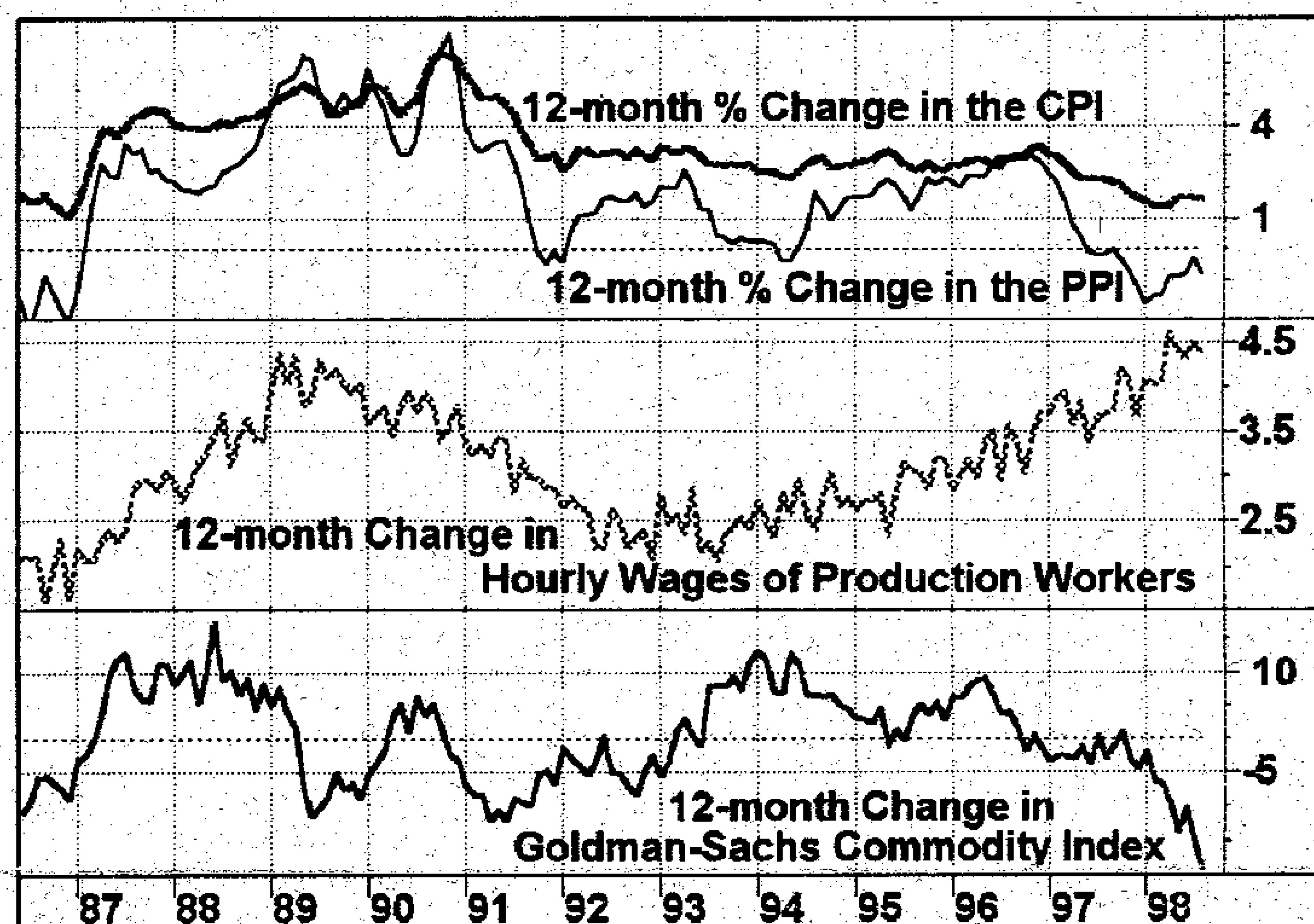
SALES Retail sales have remained relatively strong, up 4.1% over 12 months, with a few recent exceptions due to temporary influences. Auto and light truck sales were lowered by the strike in the auto industry. Home sales fell in August from an annual rate of 877,000 to 838,000, still near record highs. Hurricane Bonnie had a hand in producing the decline, as home sales in the southeast were down to the lowest level in many years. While consumer spending has remained very healthy, we are also seeing consumer confidence fall primarily because of fears that the Asian economic situation will hit here and because of the possible impeachment of our President. Uncertainties like these inevitably undermine confidence levels.

In response, the Conference Board's Consumer Confidence Index fell from 138 in June to 126 in September, and the U. of Michigan's Consumer Sentiment Index fell from 110.4 in January to 100.9 in September.

LABOR The unemployment rate rose to 4.6% and only 69,000 new non-farm jobs were added during the month of September. The manufacturing sector has lost jobs during 4 of the past 5 months, while the service sector, which has provided most of the strength, showed the weakest gain in September of that 5-month period. The average workweek has fallen to 34.4 hours, equal to the lowest in the past 2 years. This contraction has been most pronounced in manufacturing, as the average of 4.4 hours of overtime per week was the lowest in nearly 3 years. Conflicting with the data just cited, which show an easing of conditions, the average of weekly initial unemployment claims fell to 299,300 in September, the lowest in nearly 10 years (2nd chart at right). This last number means that fewer workers were losing their jobs and applying for aid. The reason for this conflicting data on jobs is not clear. In any case, the labor market still remains tight and the overall trends in the labor market are clear: unemployment is not far from historic lows and few workers are losing their jobs. The number of jobs added over 12 months (3rd chart at right) is still above its trend, although weakening slightly, and help wanted ads have continued to rise. The recent drop in the average hours worked per week and the rise in the unemployment rate are probably the beginning of a new set of conditions that will last for the next several quarters. If the growth rate of our economy slows to about 2%, compared to the 3.7% average of the past 5 years, we may well see these long-term trends reverse or at least flatten out. Shortages of workers in particular jobs like truck drivers and computer programmers may disappear and wages in general will slow their rapid rate of increase.



INFLATION The overall inflation rate in our economy, as measured by the 12-month change in the Consumer Price Index, was 1.6% in September. Wholesale prices, indicated by the Producer Price Index, fell 0.8% in 12 months. The broadest measurement of inflation in our economy is the GDP Deflator, which showed an annualized rate of inflation of only 0.85% in the 2nd quarter. The CPI-indicated inflation rate (top chart) has been remarkably steady when one considers the powerful and opposing forces at work today. The middle chart shows the 12-month change in average hourly wages of production workers, which has been accelerating over the past 5 years, reaching a peak of 4.4% in May and falling only slightly to 4.1% in September. Wages are generally regarded as being responsible for 2/3 of inflation, so this relatively steady increase has been responsible for most of the Fed's worries about inflation in the past 2 or 3 years. Shortages of workers in particular jobs have led to very rapid rises in pay in those areas, and the pool of available labor has shrunk to a size smaller than has been seen in many years. Contrasting with the tightness of the labor market and rising wages, commodity prices have fallen through the floor. The Goldman Sachs Commodity Index has fallen nearly 20% in the past 12-months, as economic weakness in Asia has dramatically decreased demand for raw materials. This particular commodity price index is trade weighted, meaning that prices of the commodities in the index are weighted according to how much they are bought and sold in our economy. This commodity index has reached lows not seen since 1977, and it is not adjusted for inflation. This is an indication of severe deflation in one part of the world's economy. Producers of everything from gold to wheat are getting less and less for their products, as production costs remain relatively steady, so profit margins have been pinched.



SUMMARY AND OUTLOOK Present economic conditions in the U.S. are nowhere near as bad as our stock market would seem to indicate. Our economy will continue to grow, probably at an annual rate of about 2%, and we have so far escaped the misery that Asia has experienced. While our manufacturing sector has been battered by the decreased demand and tough price competition coming from Asia, only a little more than 10% of our economy is based on exports. Construction and consumer products have picked up most of the slack. Dramatically lower interest rates will improve profitability as costs of borrowing decline. We will begin to see more mortgage refinancing, as borrowers take advantage of much lower interest rates. This will put more cash in many homeowners' pockets and in corporate balance sheets every month. In turn, this extra cash will offset to a great extent the drag placed on our economy by the slowdown in Asia.