THE COMPASS

A QUARTERLY NEWSLETTER FROM MARTIN CAPITAL ADVISORS

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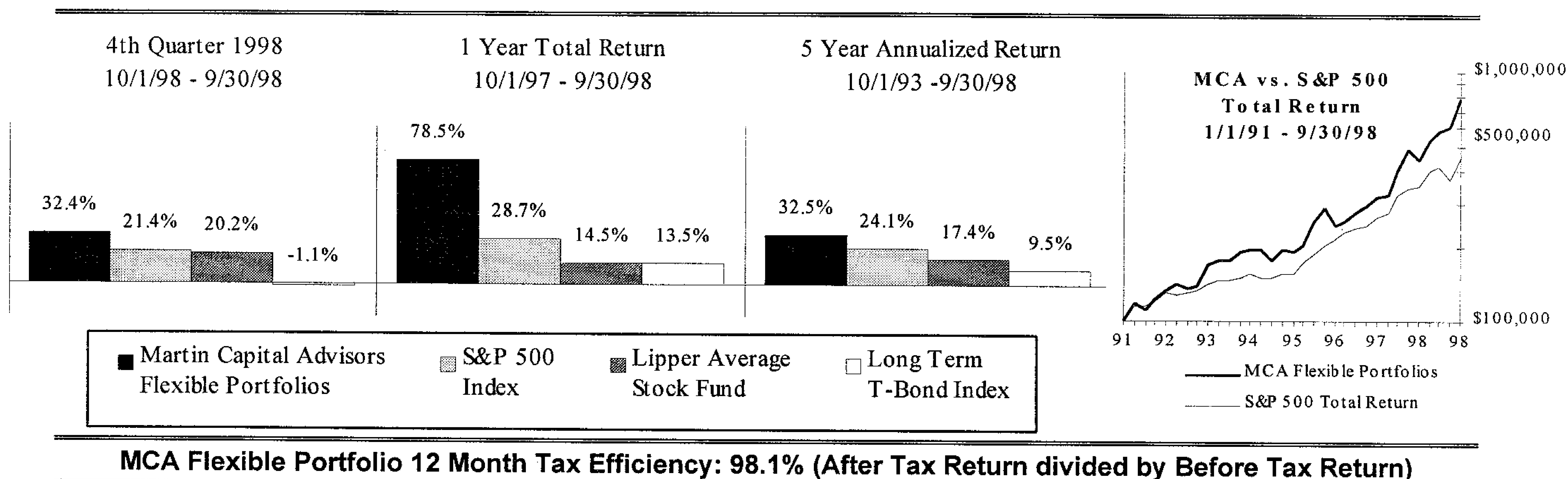
January 1, 1999

Investment Results



MCA Flexible Portfolio 12 Month Tax Efficiency: 98.1% (After Tax Return divided by Before Tax Return)

Investment Perspective

As anticipated in the last newsletter, the stock market tested the late summer lows during the first part of the fourth quarter. In the face of high anxiety and extremely negative sentiment the indices held at or near the previous lows. We became quite positive as the market began to melt down. The market action represented a classical bottom formation in a secular bull market. By incrementally increasing market exposure and selectively hedging over-extended positions, we were able to enhance returns as the stock market completed the test of the lows and surged back toward new highs. Bonds performed in line with our expectation of a slight rise in interest rates by the end of the quarter.

The beginning of the first quarter of 1999 should see some follow through to the stock market gains achieved at the end of 1998. As the indices move higher, however, we will become more wary of potential corrections. There is a fair chance that by the middle of the quarter the market will have begun to retrace approximately one third of the gains realized since October. In keeping with our long-term positive outlook we will not be significantly reducing market exposure during this period of potential weakness, but we will consider incremental increases in cash and more aggressive hedging activities as the quarter progresses. The end of the quarter may see the stock market somewhat lower than where it began. Bonds, on the other hand, may do slightly better, with long interest rates finishing back below 5%.

For the year, we expect another above average performance, but not without some pain again by the middle of the year. Most of the gains will probably occur during the latter half of the year, although Y2K paranoia could artificially depress the stock market until January 2000. If that happens, then the beginning of next year will be a tremendous time to buy stocks.

We began managing the *Austin Opportunity Fund* at the beginning of the year. This mutual fund invests in companies that are based in Austin or are among the top 25 employers in the Austin area. The minimum investment is one thousand dollars. Prospectuses are available on request.

Once again, Nelson's *World's Best Money Managers* (http://www.nelnet.com) has rated Martin Capital Advisors #1 in U.S. Tactical Asset Allocation and U.S. Balanced/Multi-Asset classes for almost all periods up through five years ending September 30, 1998. When the numbers through the end of December are reported most of the #1 ratings should be sustained. We expect to have our 1998 numbers audited by the end of March. Our 1991 through 1997 audit report is currently available on request.

Market Timing Viewpoint

Recommended Tactical Asset Allocation

Stocks 90% (Δ UNCH) Bonds 10% (Δ UNCH) Cash 0% (Δ UNCH)

Performance Expectation

	March 31, 1999		December 31, 1999		December 31, 2003	
	Target	% Change	Target	% Change	Target	% Change
DJIA/S&P 500	8750/1150	- 05.0%	10500/1400	+15.0%	20500/2750	+125.0%
Nasdaq Comp.	2050	- 05.0%	2650	+20.0%	6000	+175.0%
30 Year T-Bond	4.75%	+ 05.0%	4.50%	+10.0%	4.00%	+ 20.0%

20 Largest Common Stock Positions
(Prices as of December 31, 1998)

1 Dell Computer	73.19	6 Intel	118.56	11 Whole Foods Market	48.38	16 Sun Microsystems	85.63
2 Charles Schwab	56.19	7 Texas Instruments	85.63	12 Hewlett Packard	68.31	17 Enzon	13.31
3 S&P Dep Receipts	123.31	8 Applied Materials	42.69	13 Southwest Airlines	22.69	18 Sprint	84.13
4 Cisco Systems	92.81	9 Home Depot	61.19	14 Oracle	43.13	19 3-Com	44.81
5 Microsolft	138.69	10 Williams-Sonoma	40.31	15 Electronic Arts	56.13	20 Advanced Micro Dev	29.00

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	+ 78.5%	+ 18.1%	+ 28.7%	+ 23.4%	+ 13.5%	+ 5.0%	+ 1.5%
Total**	+692.4%	+338.8%	+354.7%	+335.89%	+136.5%	+ 41.5%	+ 22.3%
Avg.***	+ 29.5%	+ 20.3%	+ 20.8%	+ 20.2%	+ 11.4%	+ 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 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 December 31, 1998, with 3-month & 12-month Changes

Stock Indices*		3 mo	12 mo
Dow Industrials	9181	17.1%	16.1%
S&P 500	1229	20.9%	26.7%
NASDAQ Comp	2193	29.5%	39.6%
NASDAQ 100	1836	36.5%	85.3%
NYSE Comp	596	18.1%	16.6%
Wilshire 5000	11318	21.1%	21.7%
Russell 2000	422	16.1%	-3.4%

* excluding dividends

Interest Rates		3 mo	12 mo
91-day T-Bill DR	4.37%	2.8%	-16.1%
30-yr T-Bond Yld	5.09%	2.4%	-14.0%
FNMA 30yr mortg	6.66%	2.8%	-7.2%
Prime Rate	7.75%	-6.1%	-8.8%
Fed Funds Trgt	4.75%	-9.5%	-13.6%
Fed Disc Rate	4.50%	-10.0%	-10.0%
S/L Long T-Bnd Ind	8676.3	-1.1%	13.5%

Prices, Inflation		3 mo	12 mo
CPI, Nov	164.0	1.5% apr	1.5%
PPI, Nov	130.8	0.6% apr	-0.7%
Gold, cash - H&H	288.7	-2.7%	0.6%
W Tx Int Cr Oil	12.00	-25.6%	-32.6%
Copper. cash	0.66	-9.6%	-14.3%
CRB Futures Ind	191.2	-5.9%	-16.5%
CRB Raw Indust	265.3	-5.9%	-13.7%

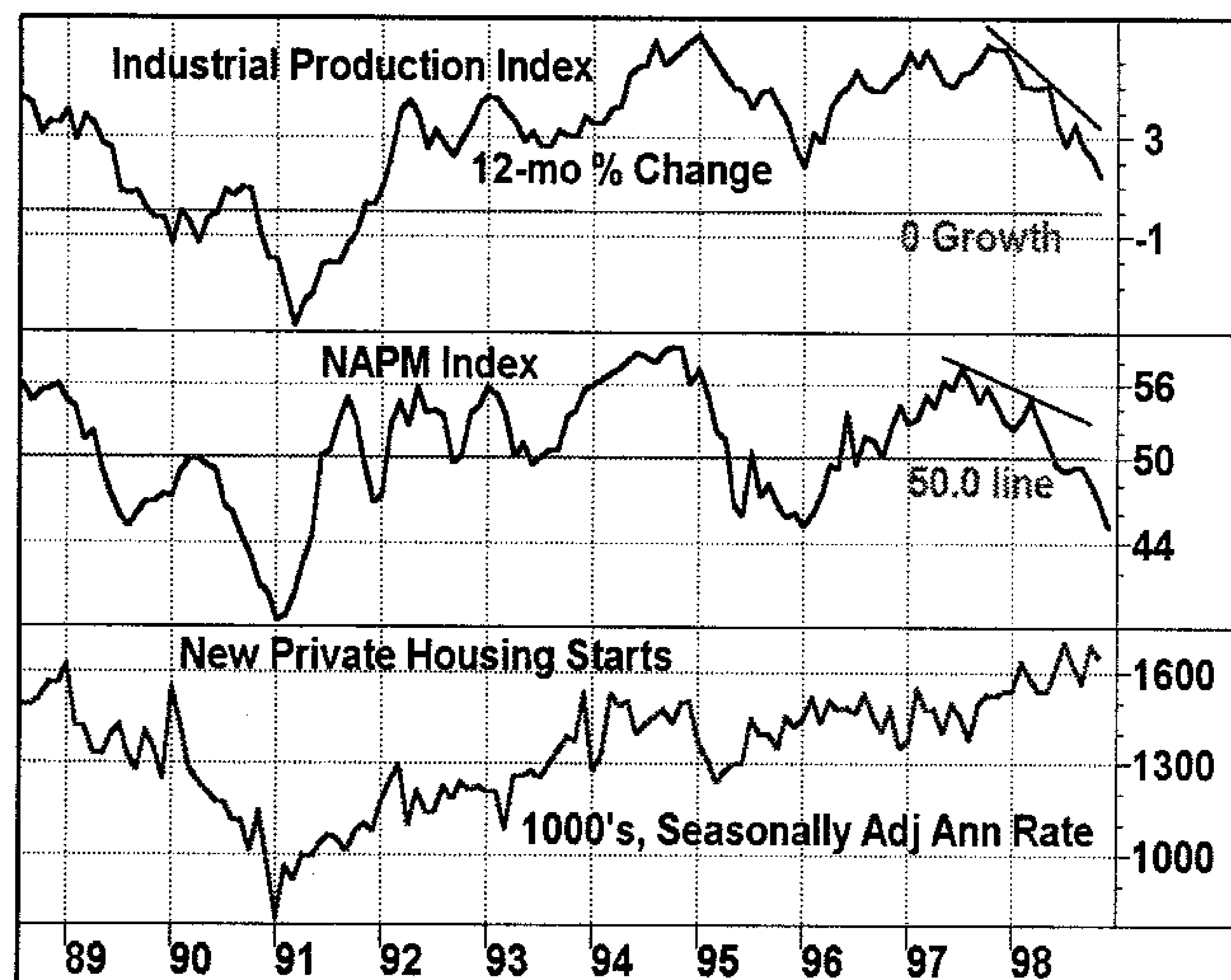
Money			
M2, Bil Curr$, Nov	4376	3.1%	8.8%
Free Reserves	1671	43.7%	41.3%
Money Mkts - Bil$	1394	9.2%	29.3%
US $$$ Index	94.08	-2.2%	-5.6%

Industry			
Indust Prod Ind, Nov	131.8	-0.5%	1.5%
NAPM Ind, Dec	45.1	-4.3	-8.0
Cap Util, Nov - %	80.6	-1.8%	-3.4%
Bldg Permits - Nov	1651	2.0%	11.9%

Economy			
GDP-Bil$, 3rd Qtr	7567	3.7% apr	3.5%
Unemplmnt %, Nov	4.4	-0.1	-0.2
Empl Cst Ind, 3rd Qtr	138.7	4.1% apr	3.6%
Leading Indic, Nov	106.3	2.3% apr	1.5%

Looking at the stock indices above, the disparity between the 85.3% gain in the NASDAQ 100 Index and the 3.4% decline in the Russell 2000 Small Cap Index over 12 months is shocking. The difference between the strong index of 100 stocks and the weak index of 2000 stocks illustrates how a small group of stocks, mostly in the high-tech sector, has been favored. As corporate earnings have been held back by a nearly deflationary environment, the high-tech area has emerged as the one with the greatest potential for rising profits. Both long and short interest rates have fallen while the money supply has risen strongly. The Fed has turned from fighting inflation this year to moving in the opposite direction against deflation. The economy as a whole has continued to expand rapidly, although not accompanied by an increase in corporate profits. Many sectors have been hurt by the deflationary tendencies.

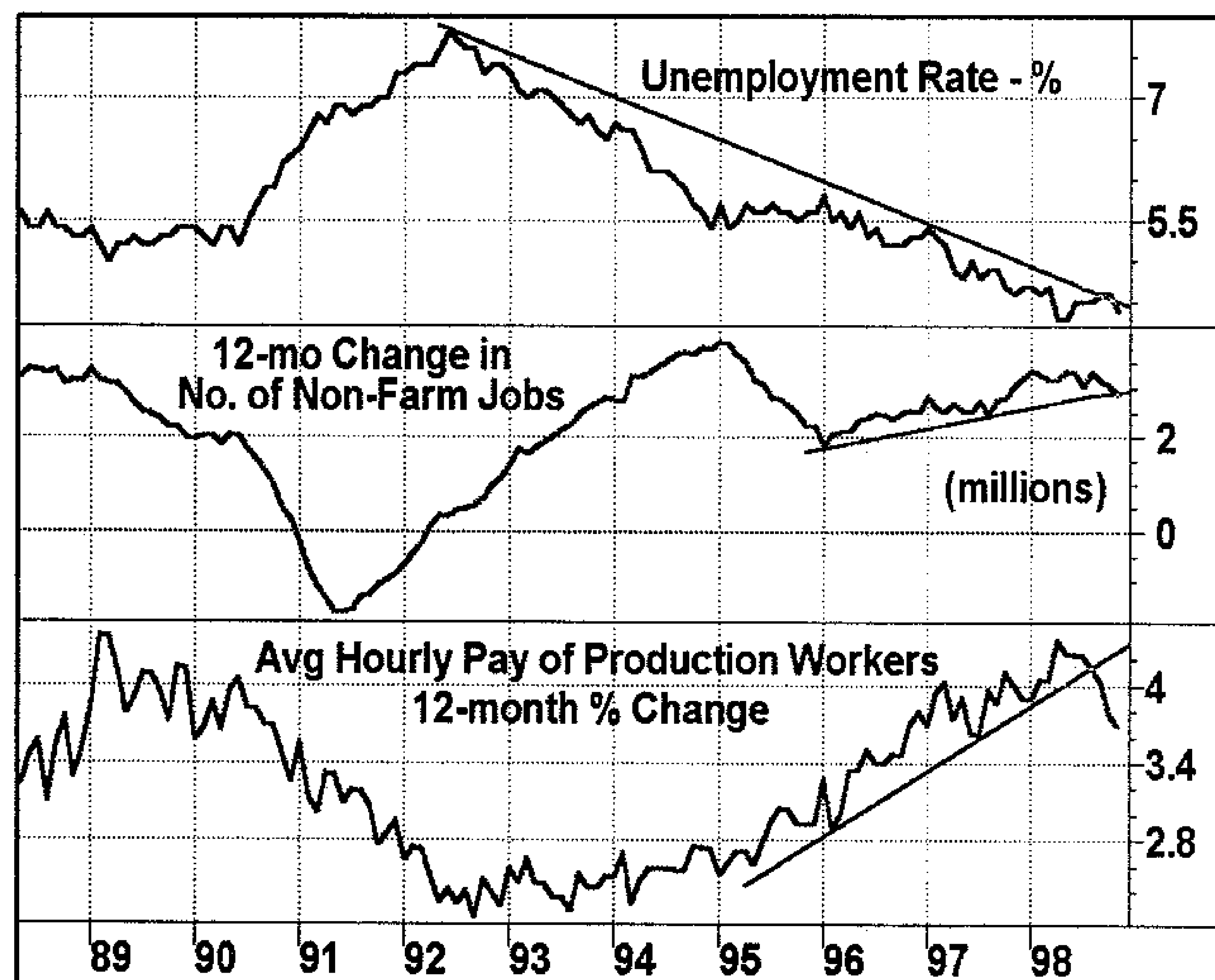
INDUSTRY The manufacturing sector of our economy continues to be weakened by the Asian economic crisis and is experiencing its own recession, regardless of what the rest of the economy may be doing. Exports of our manufactured products have declined as Asian buyers have had to contend with much weaker currencies in the midst of an outright depression. The top 2 charts at right show the rapidity and depth of the decline in manufacturing. The 12-month change in the Industrial Production Index rose by only 1.5% in November and the North American Purchasing Managers Index fell to 45.1 in December. The NAPM Index is now substantially below the 50.0 figure that divides expansion from contraction. These are the lowest such readings since 1992, during the recovery from the last recession. Manufacturers' new orders for durable and non-durable goods are both lower than they were 12 months ago. Fortunately, manufacturing is the weakest area in our economy as a whole. Housing has been very strong, powered ahead by domestic strength. The bottom chart shows how housing starts during 1998 have been occurring at the highest rate in at least a decade at the same time that manufacturing has weakened. Homebuyers have been assisted by falling mortgage rates and bolstered by high consumer confidence coming from good pay and job security.



SALES Retail sales have continued to be strong, up 6.2% in 12 months, driven by the beneficial conditions cited above of good pay, job security and low interest rates. Low prices have also helped convince consumers to spend their money. This rate of growth in retail sales is near the highest in the past 4 years. Auto and light truck sales have remained steady (except for the interruption of the UAW strike against GM), running at a healthy annual rate of about 15 million units. New home sales reached an all-time high in July and have remained near the record, in line with the strength of housing starts, shown in the chart above. We have an economy dominated more than ever by consumer demand, and as long as paychecks keep coming and job security and consumer confidence remain high, this source of strength in our economy should continue at or near current levels.

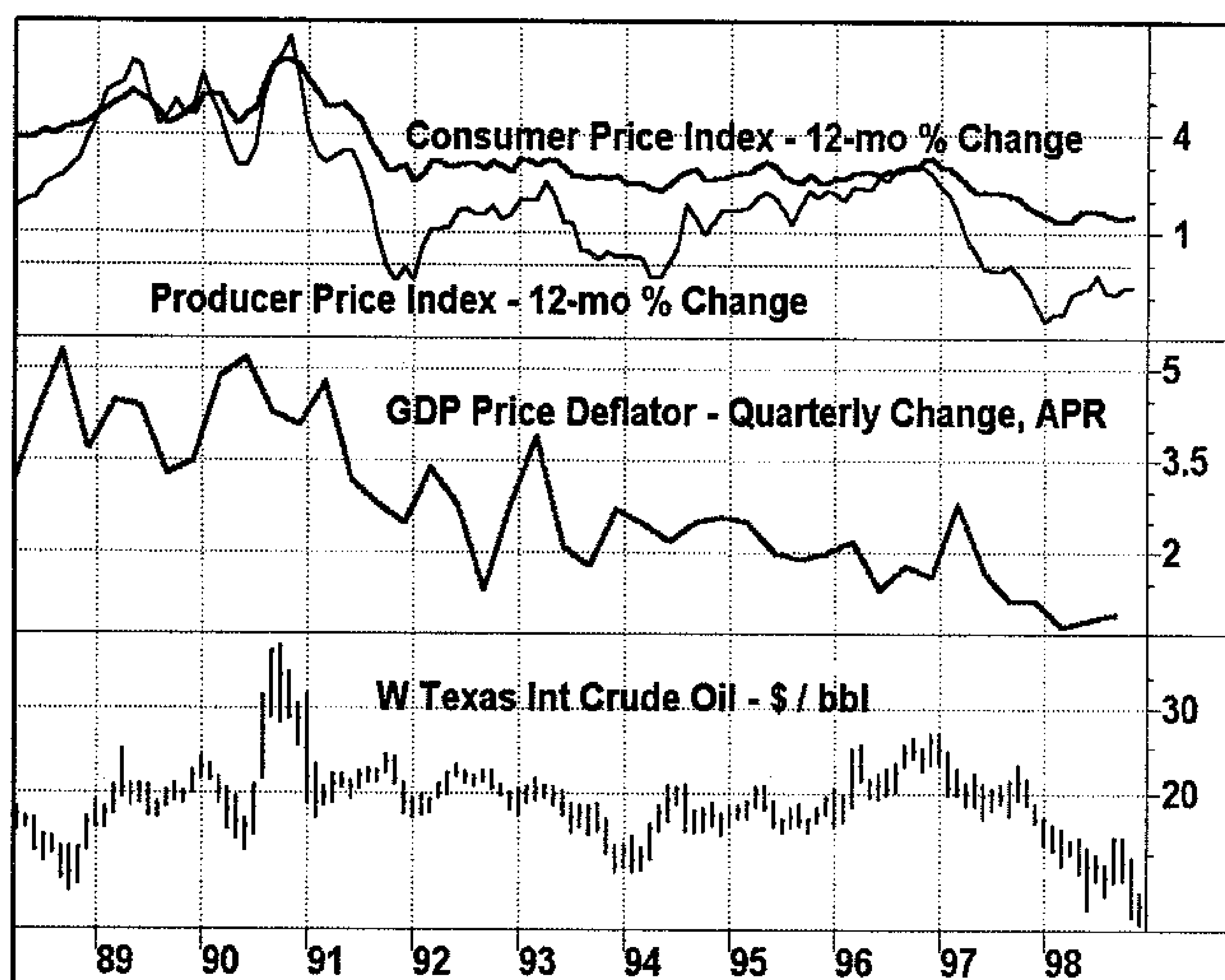
LABOR Our tight labor market has provided the power behind the strongest part of our economy while the Asian crisis has flattened our manufacturing sector. The tight labor market has meant that workers' jobs have remained secure with good pay. Any weakness in our labor market has been confined so far to sectors that are involved in competitive trade with Asia, where price cuts and reduced

earnings have led to layoffs. We've read about tens of thousands of job cuts being made in sectors like aircraft manufacturing and oil exploration and production, so there are mixed signals. Non-farm jobs have been increasing at a historically rapid rate, although the total for 12 months dropped below 3 million in December for the first time in 13 months (middle chart). This drop might be a sign of a slight weakening in the job market. Nevertheless, the unemployment rate in November was 4.4%, just above the 30-year low of 4.3% reached in April and May. The number of initial unemployment claims, a measure of the number of workers laid off, has remained low so far without showing any significant tendency to rise. This is somewhat surprising when one considers the large number of jobs being cut in hard-hit industries. The average number of hours worked per week has declined very slightly since the beginning of 1998, but has held close to 34.6, roughly the average of the past 3 years. An indication of strong demand in the labor market comes from the Conference Board's Help Wanted Index, which rose to 91 in November, near the highs of the past year and also near the highest levels since 1990. The bottom chart shows the decline in the rapid rate of increase in the hourly pay of production workers. This is a classic lagging indicator. Production workers have been the hardest hit by the shrinking manufacturing sector. As exports and manufacturing began to contract, the demand for workers ceased to rise so fast. Wages, which had been rising at a rate far higher than the overall inflation rate, began to rise more slowly.



A much weaker labor market would be a very unfavorable development for our economy. Higher unemployment and fewer jobs being created would lessen the power of consumer spending, which makes up over 2/3 of our economy. So far, we have avoided any serious effects from the Asian depression by having an unusually large portion of our workforce employed and earning good wages. If this bulwark against economic weakness should start to give way, we might roll into a recession.

INFLATION The overall rate of inflation in our economy, indicated by the 12-month change in the Consumer Price Index, is 1.5%. The GDP Deflator, the broadest measure of inflation in our economy, showed an annualized inflation rate of only 1.0% in the 3rd quarter. Prices of industrial raw materials have been seriously depressed by lack of demand from Asia, so the Producer price Index of wholesale prices has fallen by 0.7% in 12 months. Grain prices have also fallen, another area affected by lower demand from Asia. The key commodity price that influences our inflation rate more than any other is that of crude oil. Before the Arab oil embargo in 1972, crude oil was selling for about \$2.90/barrel. Today's price, adjusted for inflation by the CPI, is only about \$2.75/barrel. This has been beneficial for most of our economy, but devastating for producers in the industry. Costs of exploration and production have gone up rather than down after adjustment for inflation. Consequently, companies like Exxon are now replacing only about 80% to 85% of the oil they produce. Nevertheless, they are putting lots of money into deepwater exploration. This is being done in an effort to establish large reserves in offshore areas they will be able to tap without oil going ashore and being vulnerable to political unrest. This implies that they expect oil prices to rise eventually, as demand finally catches up with supply over the long term, but that is at least several years ahead.



MONETARY POLICY The Fed has cut short interest rates in an effort to prevent the waves of deflation from washing over our American shores. While real rates after adjustment for inflation are still relatively high by historic standards, the money supply has expanded at an extremely rapid rate. The M2 measure of the money supply has grown 8.8% and the broader M3 measure by 11% in 12 months. A "normal" rate of growth would be 5%. This is a stimulative move to counteract the drag of falling prices. With real rates still high, the Fed has a lot more room to cut before real rates reach historic lows.

SUMMARY AND OUTLOOK We are faced with a tug-of-war between forces that pull us in opposite directions at the same time, some toward a stronger and some toward a weaker economy. The forces of weakness and deflation are coming from Asia and are undermining our exports and our pricing. With weakness in pricing, profits are hurt. The inevitable result of squeeze on profits like this is consolidation and job cutbacks. If we start to lose too many jobs, the main source of strength in our economy will be weakened. Our main strength today is consumer spending. This spending depends upon a large proportion of workers being employed and contented, rolling their paychecks back into purchases that keep the economy going. The rate cuts by the Fed are another force adding strength in order to counteract the drag of deflation on corporate profits and the economy as a whole. I expect that the expansionary policies of the Fed, along with other positive moves in the future, will be enough to keep our vibrant economy from slipping into a recession. Growth will slow somewhat, but we will still see gains.