THE COMPASS

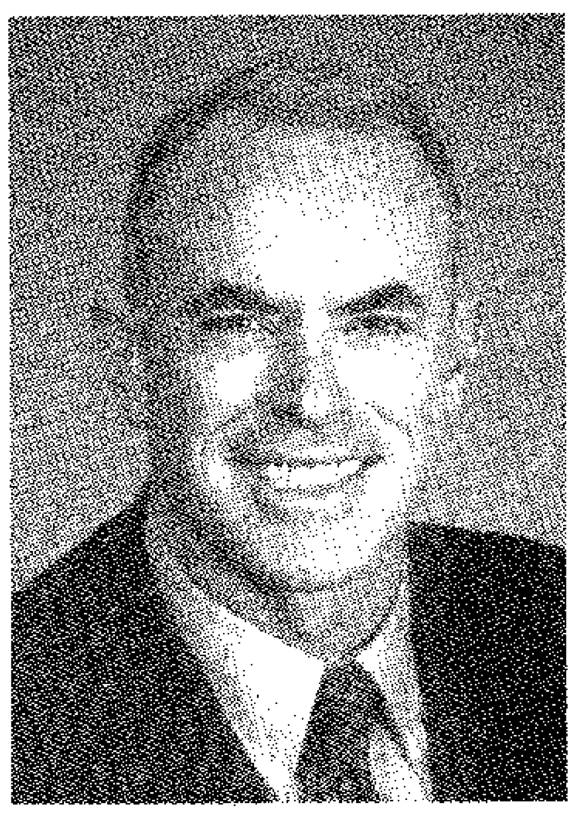
October 1, 1999

A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Long-term outlook bullish as Y2K approaches

Third quarter returns were mixed. Although we entered the quarter with a neutral viewpoint, most financial indices finished at the low end of expectations. Fear of inflation was the primary cause of the decline in stock and bond prices. We have stated in the past that inflation will remain under control for many years to come, but the high inflation of the seventies and eighties is still on the minds of many investors and regulators, causing financial markets to tremble any time there is the slightest hint that inflation may stage a counter-trend rebound against predominantly disinflationary forces.



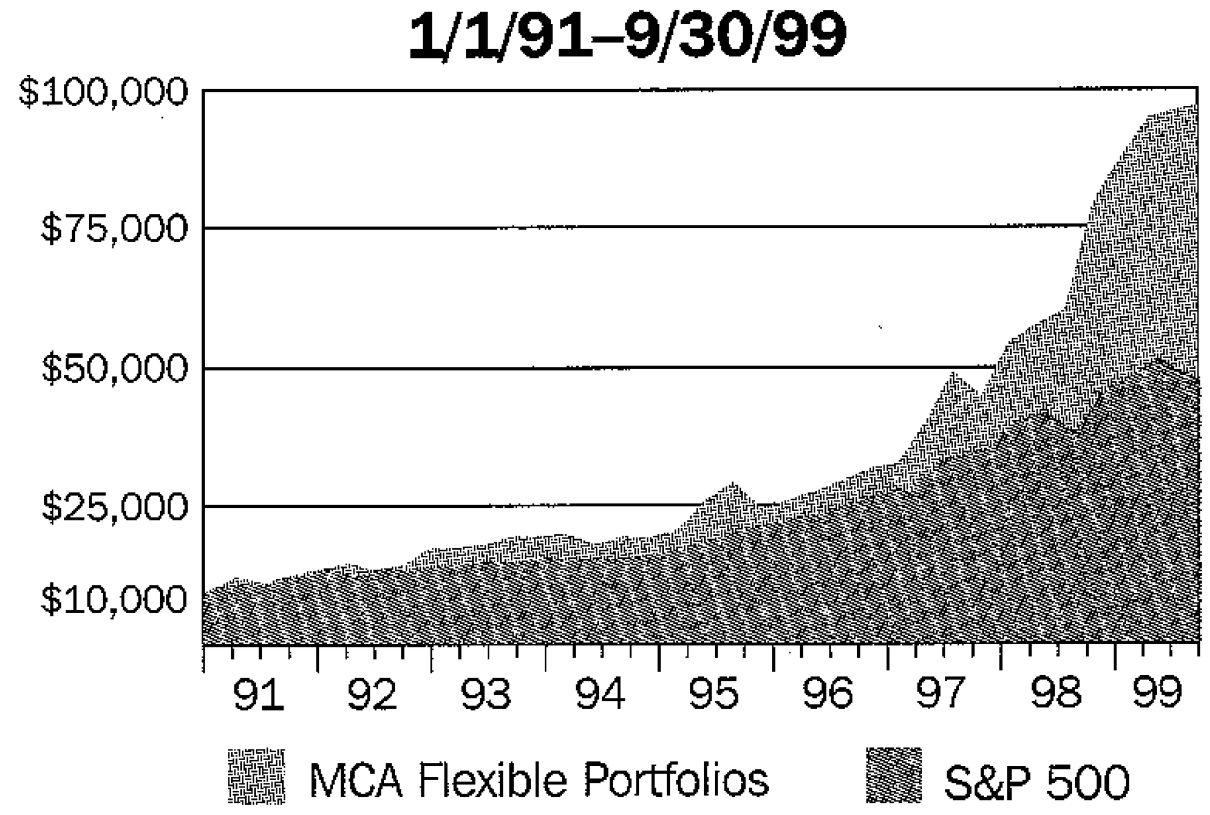
For the fourth quarter we will maintain a neutral outlook. There are many unpredictable short-term factors that could cause the financial markets to move one way or the other. Primary concerns are Y2K and Federal Reserve Board policy. They will have a positive or negative impact depending on how they evolve during the quarter. Corporate earnings should be quite good, but it's hard to say how much they have already been factored in to current stock prices. Given our long-term bullish outlook, we will tend to remain fully invested, but in the event of a significant move in one direction or the other, we will make an incremental shift in the opposite direction.

The Martin Capital Austin Opportunity Fund began operations at the beginning of September. The fund invests in companies headquartered or having significant operations in Austin. The minimum investment is one thousand dollars. A prospectus is available on request. The Texas Opportunity Fund should be available for purchase by the end of the year. We are now accepting indications of interest for this fund. The Martin Capital U.S. Opportunity Fund is performing well; as of the quarter's end, its NAV per share was up 4.5% from inception, and as of this writing, has improved further. Information on our mutual funds, as well as other news and information about Martin Capital, can be obtained through our website.

Plan Sponsor Network's latest rankings place Martin Capital's flexible portfolios' performance in the top one percent of the managed portfolios they track for all periods through seven years. Copies of their report are available on request. Also, an independent performance review for 1991 through 1998 by the certified public accounting firm Jeff D. Heard, Jr., P.C., is available on request.

Finally, you will note some changes in our communications materials. We have developed new stationery and brochures, and *The Compass* has received a facelift designed to improve readability and appearance. For the full effect of all these enhancements, please visit our website, www.martincapital.com, which has been fully revised as well. Your comments are welcome.

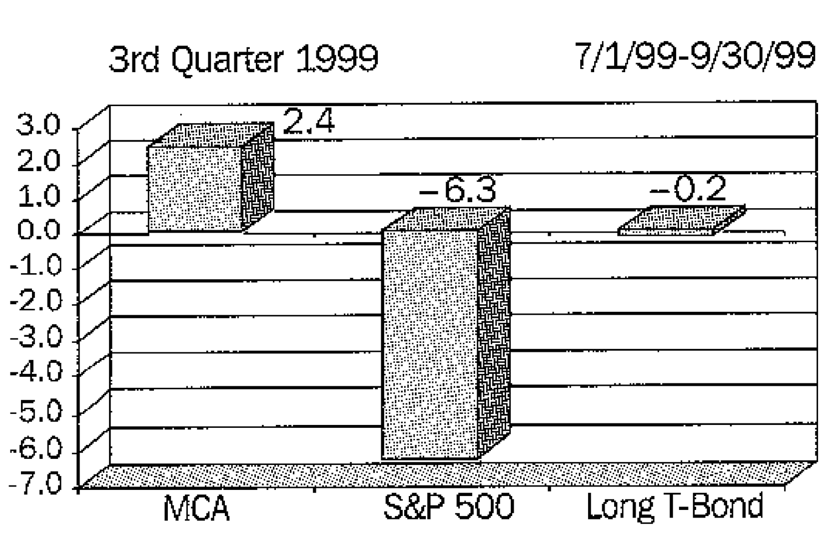
Martin Capital Advisors vs. S&P 500
Total Return
1/1/91–9/30/99

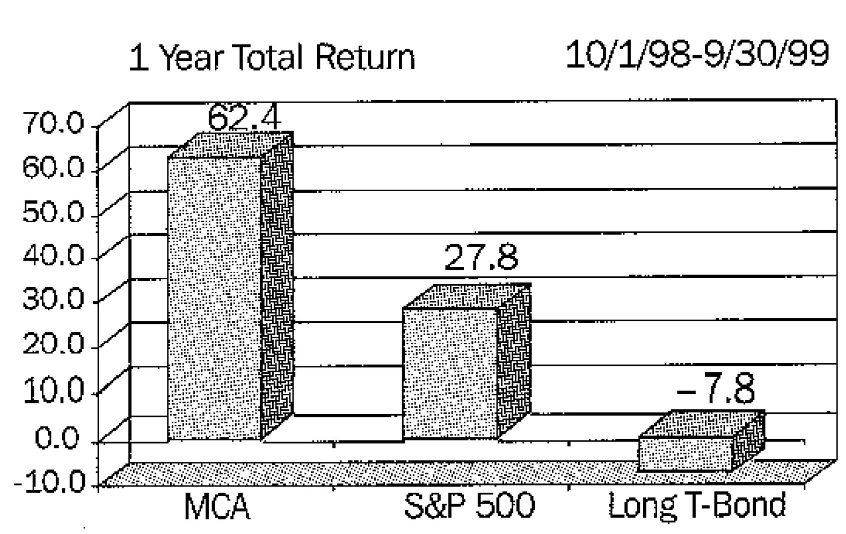


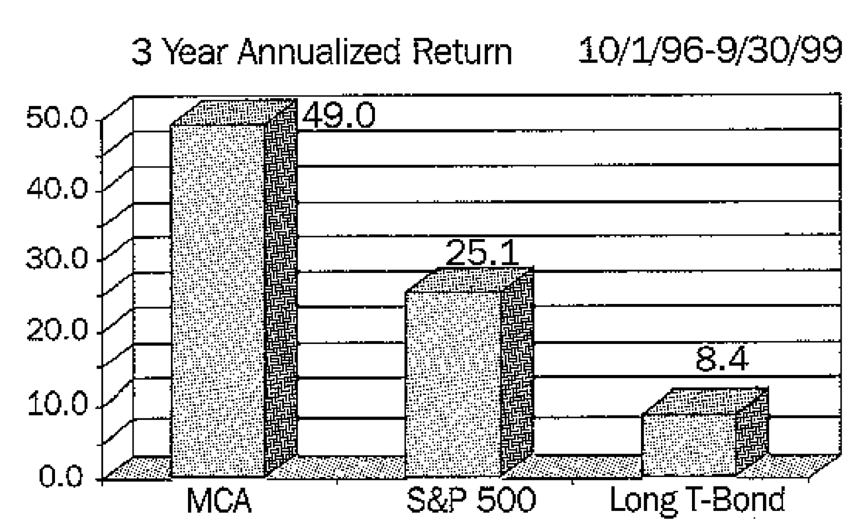
MCA Flexible Portfolios
12-month Tax Efficiency: 98.2%
(After Tax Return divided by Before Tax Return)

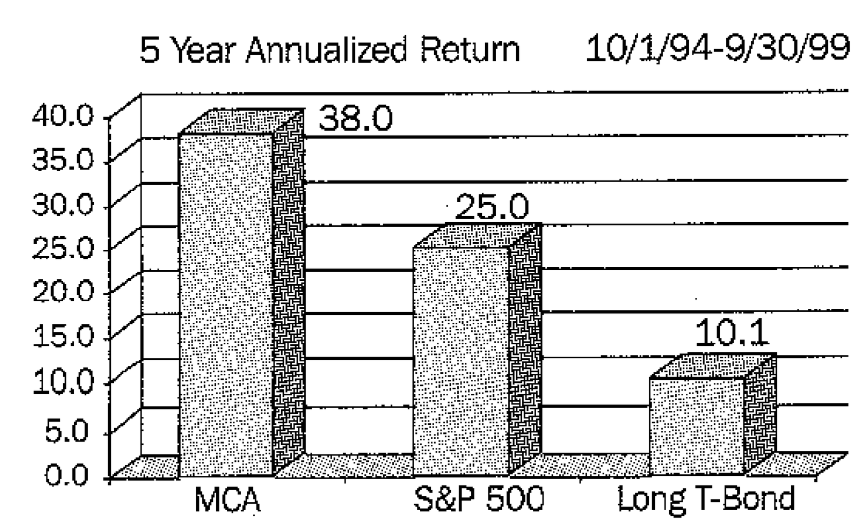
INVESTMENT RESULTS

Martin Capital Advisors Flexible Portfolios vs. the S&P 500 Index and the Lehman Brothers Long Treasury Bond Index









MARTIN CAPITAL
ADVISORS

QUARTERLY ECONOMIC REVIEW by Alston Boyd, Economic Director

Market and Economic Statistics as of Market Close on September 30, 1999, with 3-month and 12-month changes

STOCK INDICES*		3 mo	12 mo
Dow Industrials	10337	-5.8%	31.8%
S&P 500	1283	-6.6%	26.1%
NASDAQ Comp	2746	2.2%	62.1%
NASDAQ 100	2408	4.8%	79.0%
NYSE Comp	593	-8.5%	17.5%
Wilshire 5000	11714	-6.9%	25.3%
Russell 2000	427	-6.6%	17.5%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	4.83%	3.6%	13.6%
30-yr T-Bond Yld	6.04%	1.2%	21.5%
FNMA 30yr mortg	7.86%	3.6%	21.3%
Prime Rate	8.25%	3.1%	0.0%
Fed Funds Trgt	5.25%	5.0%	0.0%
Fed Disc Rate	4.75%	5.6%	-5.0%
S/L Long T-Bnd Ind	8090	-0.2%	-7.8%

PRICES, INFLATION		3 mo	12 mo
CPI, Aug	167.1	2.2% apr	2.3%
PPI, Aug	133.7	3.9% apr	2.6%
Gold, cash	297.7	14.1%	0.3%
W Tx Int Cr Oil	24.47	31.8%	51.7%
Copper, cash	0.82	7.9%	12.3%
CRB Futures Ind	205.2	7.1%	0.9%
CRB Raw Indust	273.0	5.1%	-3.1%

MONEY			
M2, Bil Curr$, Aug	4562	1.3%	7.6%
Free Reserves	657	-36.6%	-43.5%
Money Mkts - Bil$	1496	2.8%	17.2%
US $$$ Index	98.5	-4.1%	2.5%

INDUSTRY			
Indust Prod Ind, Aug	135.6	1.2%	2.8%
NAPM Index	57.8	0.8	8.7
Cap Utiliz, Aug	80.8%	0.4%	-1.2%
Bldg Permits - Aug	1612	1.3%	2.7%

ECONOMY			
GDP-Bil$, 2nd Qtr	7791	1.6% apr	3.9%
Unemplmnt %, Aug	4.2%	0.1%	-0.2%
Empl Cst Ind, 2nd Qtr	140.2	1.1% apr	3.2%
Leading Indic, Aug	107.9	1.9% apr	2.2%

The large 12-month changes in stock market indices show that big gains have been made, but the three-month changes show that it certainly wasn't done in the last quarter.

An environment of higher interest rates has been the main culprit. Inflation has remained tame, with only the price of oil increasing at a rapid rate. The industrial sector of the economy has recovered from last year's sinking spell caused by Asian problems.

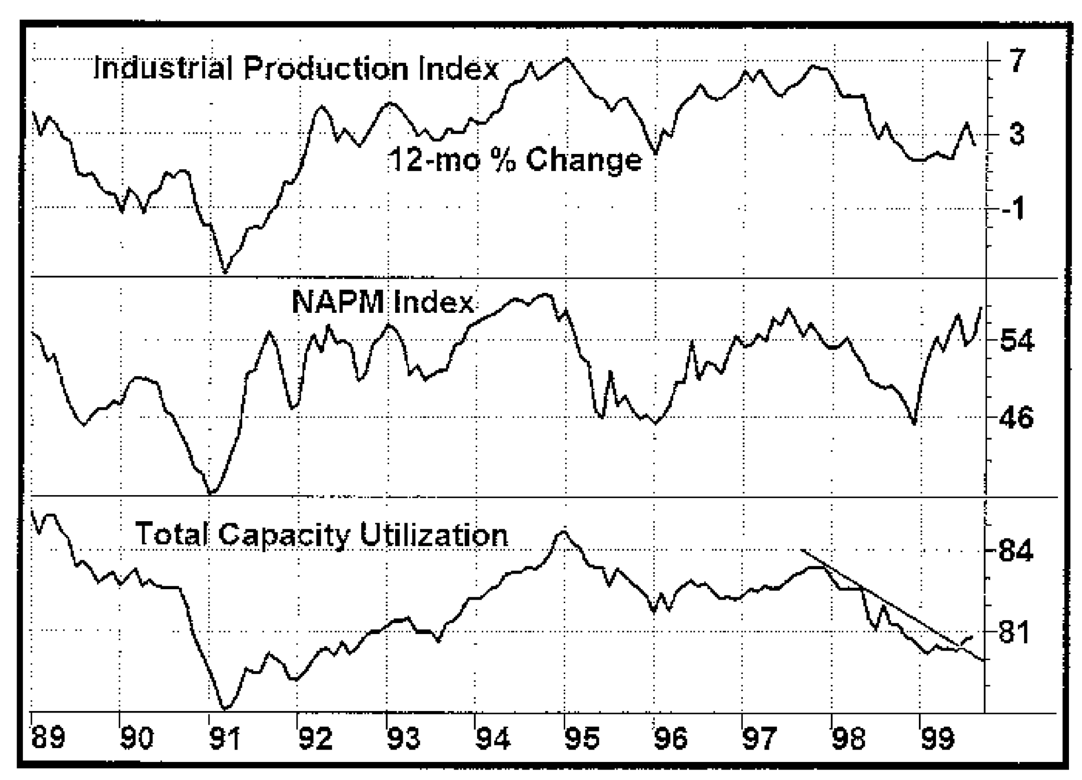
Our economy continues to grow at a healthy pace despite some concerns that higher interest rates might cause it to slow.

MANUFACTURING

The manufacturing sector of the U.S. economy began to recover in the first quarter of 1999, speeded up in the second quarter, and continued strong in the third. The Industrial Production Index increased 0.3% in August, and was up 2.5% over 12 months. The North American Purchasing Managers Index reached a five-year high in September, reflecting accelerating growth in manufacturing. This was the eighth month above 50, showing continuous expansion over that period.

Total capacity utilization of industry bottomed out late last year and has finally broken the downward trend line, rising to a relatively weak 80.8%. Capacity utilization of manufacturing has followed this pattern very closely, at a slightly lower figure, 79.8% in August. Factory orders that were flat over 12 months through last fall have perked up, showing an increase of more than 7% over a similar period in July, the last month measured.

The main contributor to this turnaround has been the figure for non-durable goods, which has risen sharply since last fall. In contrast, durable goods have maintained a higher and steadier rate of growth than non-durables. The relatively high rate of spending on durable goods and the low level of capacity utilization are related. Manufacturers are eager to spend on new, higher-tech equipment in order to increase efficiency and lower production costs. With no power to raise prices, businesses are forced to increase efficiency as a way to increase profits and offset higher wage costs.



Construction spending has fallen since early this year because of higher mortgage rates, although it appears to have affected commercial projects more than individuals buying houses. Total spending on construction has fallen every month since April, but building permits for single family homes and housing starts fell a little, then stabilized at historically high levels over the second and third quarters of this year. Higher debt service apparently made some commercial projects unfeasible, but hasn't yet managed to severely dent consumer demand. This continued strength is surprising, as mortgage interest rates rose a full third off their lows of last fall, causing a similar increase in the size of mortgage payments for loans of a given size.

SALES

Strong consumer spending has spurred sales in almost all areas. Retail sales grew 10.6% over 12 months, a growth rate exceeded only three times in the past 15 years. Auto and light truck sales are flirting with historic highs, and the six-month average is at an all-time high. Sales of both new and existing homes have remained very strong, surprisingly so in view of the big increase in mortgage rates that has taken place since late last year.

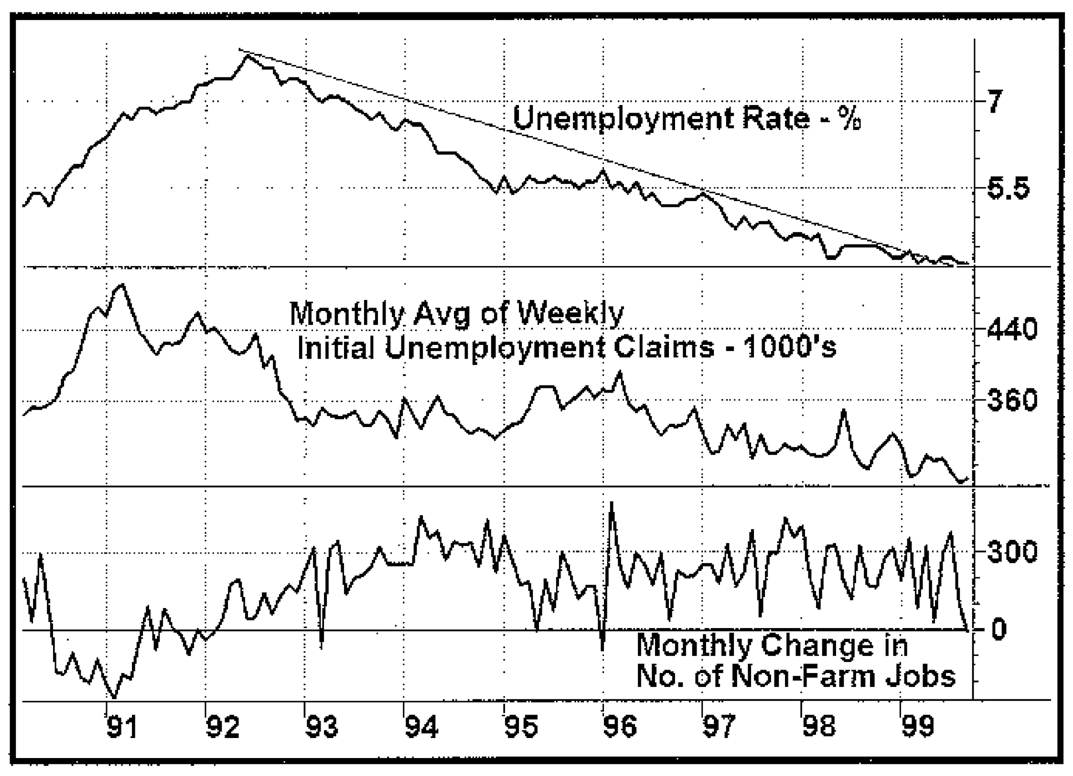
The six-month averages of both types of homes are at record levels. This flood of sales and spending has come from consumers who are making good wages and are confident about their jobs and their futures. This confidence encourages them to buy rather than put money away for a rainy day that seems very unlikely to occur anytime soon.

LABOR

The labor market remains very tight, with the unemployment rate at 4.2% in August, equal to the lowest rate since early 1970. The rate has remained between 4.2% and 4.3% since December of last year, a performance unmatched since the years 1966 to 1969. Another strong indication of a very tight labor market is the monthly average of initial unemployment claims, which are filed by people who have just lost their jobs.

The average for August was 286,000, the lowest since the early 1970s, when the total number of workers in this country was much smaller. The number of new jobs in our economy each month has been unusually volatile this year, although the monthly average of about 200,000 for the last six months is close to the average of the past three years. The number of hours worked per week and the number of overtime hours are not at extreme highs.

The overall picture of the labor market is one of many people working and few of them losing their jobs. Few



remain in the pool of people available for work while the number of jobs continues its strong and steady growth. Wages in this environment are increasing faster than the overall inflation rate, but productivity has been increasing at a nearly equal rate, so there has been no inflationary impact. Hourly wages have been rising at an annual rate of 3.5% to 4.4%.

The Employment Cost Index, a broader measure that includes benefits, rose 3.2% in the last four quarters. The latest index of labor cost per unit in manufacturing was 93.9% of the average for 1992, a substantial decrease resulting from greater productivity and efficiency. While there are shortages of workers in a few fields that might lead to sharply higher wages there, such shortages are not widespread.

INFLATION

The subject of inflation is always on the collective mind of the financial markets, especially after the Fed has recently raised interest rates. Today's conditions are unusual in that we are experiencing a low "background" rate of inflation while a few areas are causing concern. The most widely publicized inflation rate is the 12-month change in the Consumer Price Index, now at 2.3% (top chart at right, thin line).

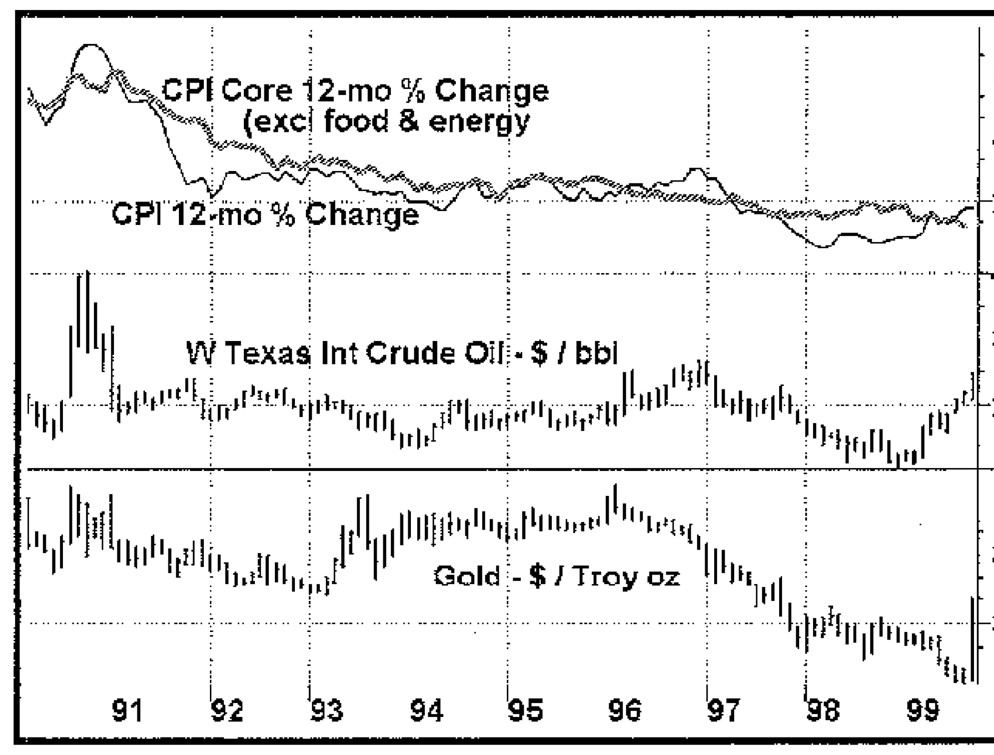
The Producer Price Index of wholesale prices is increasing at the same 2.3% rate. The CPI Core rate excludes food and energy, as these tend to be more volatile at times than other components. Thus, the Core rate gives a pretty good look at a background or underlying rate of inflation. (This is not to say that the price of oil does not have a strong impact on our inflation rate, just that the volatility can be confusing.) The Core rate of inflation has fallen to 1.9%, the lowest such rate since 1966 (top chart, wider line).

The fall in the price of oil (middle chart) that took place from late 1997 through 1998 was caused primarily by the Asian economic crisis and the reduced demand for oil that resulted. The upturn in oil prices that began early this year resulted partly from the beginning of a recovery in Asia, but mostly from a cut in oil production by OPEC and other oil producing countries. The CPI inflation rate turned up more sharply at about the same time as oil prices, while the Core rate of inflation fell further.

The comparison of these two inflation rates means very simply that the only force having any significant impact on higher inflation now is rising oil prices. The price of gold, the most traditional measure of inflation, took a big jump from below $260/oz at the end of the quarter to over $300 because of an announcement that central banks would not be selling as much as had been expected. Some of this price increase will probably stick, but how much remains to be seen.

Other raw industrial commodity prices such as copper, zinc, scrap iron are also recovering as Asia's regional economy is beginning to pick up. Prices of these commodities, however, have far less of an impact on the inflation rate than that of oil.

The tight labor market is the primary source of worry for the Fed in its actions of raising interest rates.



In an inflationary scenario, the combination of a small pool of available workers and strong job growth leads eventually to an extreme shortage of workers. Under those conditions, desperate employers might compete for workers by offering much higher wages in order to fill key positions.

If this practice became widespread, it could start a wage-price spiral and ignite inflation. Today, many jobs are being exported to factories overseas and thus avoiding the tight U.S. labor market. In decades before this one, such an ability to export manufacturing capabilities was nowhere near as widespread. With increasing productivity and the Core rate of inflation at a 33-year low in spite of continued low unemployment, the threat of harmful wage inflation seems overrated.

SUMMARY AND OUTLOOK

The factors that had been expected to bring slower economic growth seem to have been unable to hold back our resilient economy. Higher long interest rates failed to slow housing sales and consumers have continued to spend on cars and smaller items, as well. In view of the steady, low rate of inflation, it is unlikely that interest rates will climb much higher. Our manufacturing sector will continue to recover; as it does, finding workers to fill vacant positions may become more difficult. More increases in productivity will offset most of the increases in wages, keeping inflation under control.