THE COMPASS

Fourth Quarter, 2003 **A Quarterly Newsletter of Martin Capital Advisors, LLP**

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Economy and stock market rebound as monetary stimulus takes hold

October 11, 2003

Stocks continued the rally begun last fall as the economy showed further signs of improvement during the third quarter. Bond yields rose and prices declined during the quarter as deflation fears subsided and the inflationary implications of faster growth resurfaced.

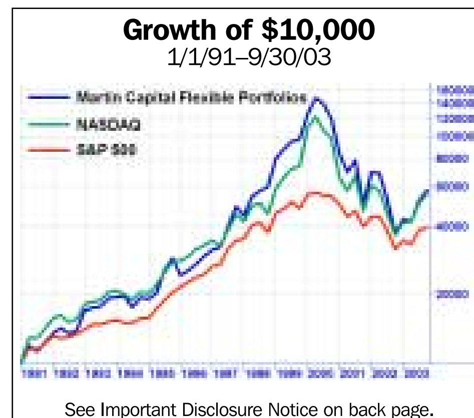
As we enter the fourth quarter, stronger corporate earnings are beginning to reflect the resurgence in economic activity. Significant short-term fiscal stimulus, primarily in the form of deficit spending and tax incentives, has contributed to current increases in economic expansion. Monetary stimulus is having an even greater positive impact, especially the Federal Reserve's extremely accommodative interest rate and money supply policies, which should sustain higher than average rates of growth for at least the next several years.

If the sea change in Fed policy of less concern about inflation and greater tolerance for faster growth holds true, then corporate profits have the potential to increase substantially for an extended period of time. This should result in higher stock prices, but probably would not be beneficial for bond prices. Interest rates, however, may still remain low and bonds may at least achieve historical rates of return of around five to six percent, if the disinflationary forces of high productivity and globalization persist.

Although threats of terrorism and geopolitical instability will probably remain a fact of life for the foreseeable future, the monetary and fiscal stimuli already in place should mitigate much of the adverse impact of additional disruptions on the economy and the stock market. Despite the ongoing problems in Iraq (and the negative ramifications for the political prospects of the Bush administration), Americans have begun to adjust, as they always have in the past, to the new challenges of the twenty-first century. Financial markets today have largely discounted in current prices the potential for further terrorism and geopolitical instability. Even though this adjustment will be a factor in the pricing of financial assets for many years to come, productivity enhancing conditions, such as technological advances, global competition and U.S. baby-boom demographics, combined with the Fed's commitment to maintain an accommodative monetary policy, should result in above average economic and stock market performance in the long run.

MCA Flexible Portfolios
12-month Tax Efficiency: 100.1%
(After Tax Return divided by Before Tax Return)

Growth of $10,000
1/1/91–9/30/03



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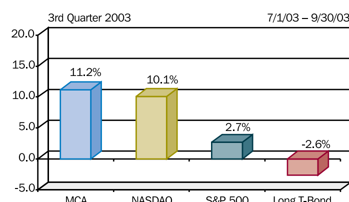
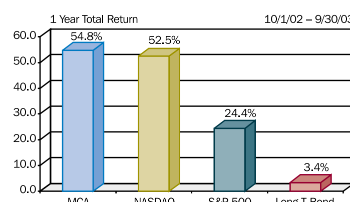
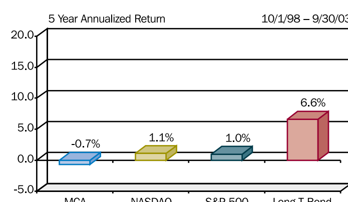
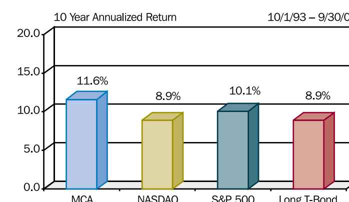
INVESTMENT RESULTS

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









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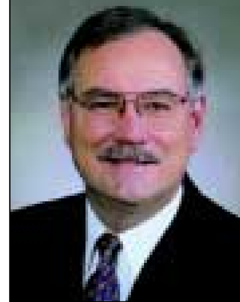
MARTIN CAPITAL
ADVISORS

Final figures for the second quarter of 2003 show that the US economy expanded at an annualized rate of 3.3%, the best in three quarters. Growth in the third quarter has been even stronger, with growth estimates in the 4%-5% range, making it the seventh consecutive quarter of growth. All major stock indexes showed gains during the last quarter, with the NASDAQ leading the pack, up 10.1%. Short interest rates changed little, if at all, while long rates rose slightly off extreme lows. Inflation remained low; however, price increases were noted in gold and industrial materials. The M2 money supply measure increased at a rapid 8.1% rate over 12 months, while the US Dollar Index declined 13.1%. The manufacturing sector showed some improvement in the third quarter, while the labor market remained weak.

INDUSTRY

The manufacturing sector experienced a severe decline in 2000 from which it has not recovered. This is clearly illustrated in the top chart of total capacity utilization of industry, which stood at 74.6% in August while that of manufacturing was lower at 72.7%. The Institute for Supply Management's Manufacturing Index showed signs of a tentative recovery in 2002, but early 2003 showed a further downturn. The third quarter, however, showed three straight months of expansion, giving evidence of what one hopes is an enduring recovery. The Index stood at 53.3 in September, on a scale that uses 50.0 as the dividing line between expansion and contraction.

Manufacturing has contracted to make up only about 15% of our economy today, a huge decline, while services have increased to make up over 75%. Most of our economy is doing much better than the manufacturing sector. The ISM Non-Manufacturing Index, also called the Service Index, has stood at over 60 for the past four months, using a 50.0 division between expansion and contraction. Home-building has outperformed the rest of the economy, as the bottom chart above shows a strong uptrend in building permits during the same period as the manufacturing slump. Low mortgage rates have made housing affordable for many because of low monthly payments.



SALES

Consumer spending has continued to be the main strength behind our economy, while business spending has continued to lag. Retail sales were up 0.6% in August and 4.9% in 12 months, a respectable performance. Auto sales have remained strong, helped by manufacturers' incentives like zero-interest financing. Month-to-month figures have been volatile since 2001, but have stayed close to 17 million units per year. Both new and existing home sales have been boosted to new records by the lowest mortgage rates in more than a generation. These low rates have put home ownership within reach of many people who otherwise could not afford them and many have taken advantage of the opportunity.

LABOR

The labor market represents the biggest problem in our economy today, with a net loss of 336,000 jobs this year. All months from February through August showed non-farm job losses, but an increase of 57,000 was indicated in September, a welcome change. The unemployment rate was down to 6.1% in August and September from a high of 6.4% in June, partly because a number of people had given up looking for work and weren't included in the number of unemployed. Though 6.1% unemployment is low by historical standards, having the number of non-farm jobs shrink seven months in a row is problematic. Weekly initial unemployment claims have been hovering around 400,000 for two years, just above what might be expected if new jobs were being created.

Though our economy is gaining steam now, we are in what many call a "jobless recovery". Several factors are responsible. The labor market typically lags the rest of the economy in recovering after a recession, but this alone doesn't explain the problem. Increased productivity is partly responsible, as the high-tech revolution continues to work its magic, making businesses run more efficiently and eliminating jobs in the process. Another important factor is the migration of jobs overseas as globalization impacts the labor market. This was a good thing back in the late 1990s, when we were near full employment, as it helped keep labor costs from going through the roof. Today, however, with many in this country looking for work, both increased productivity and cheaper offshore labor are working against us. The highest estimate of the number of jobs that have migrated overseas comes from Economy.com, with a figure of 995,000 jobs lost since March 2001. The low estimate of 500,000 to 600,000 comes from Forrester Research, Inc., though they say it might be as high as 800,000. Putting this in perspective, these estimates show that at least 15% of the 2.8 million jobs lost since the economic

decline began have moved overseas, which is enough to raise the unemployment rate by 0.4%. By 2015, we may lose as many as 3.3 million jobs. Most jobs lost so far have been in manufacturing but more and more are white-collar jobs.

Looking forward to the near term, strong evidence exists that the economic

expansion is gathering momentum. This will mean more jobs created as business spending increases, though the economy will need to grow more strongly than in the past to create the same number of jobs. Thus, we may expect to see the number of employed people in this country climb slower than in the past, not just in manufacturing but also service industries.

INFLATION

We appear to be at a balance point today between inflation and deflation. The current rate of inflation, as indicated by the 12-month change in the Consumer Price Index, is 2.2%, moderate by most standards. The core rate of inflation, which excludes food and energy, is 1.3%, the lowest since January 1966. The difference between the two rates is chiefly due to energy. The GDP Implicit Price Deflator, which essentially measures everything in our economy, rose at an annualized rate of 1.0% in the second quarter and 1.5% over 12 months, unusually low. On the other hand, gold is up 50% and oil 60% since early 2001. Commodity price indexes have also surged upward. Part of the uptrend in commodity prices is due to the fall in the value of the US dollar, down 22% from its high. The dollar simply buys less than it used to. Other potential causes of the higher gold price are a flight to safety and an expectation

of higher inflation in the future, both of which are likely at work. Oil, on the other hand, has been kept up by OPEC, which has cut production in other countries as Iraqi crude has begun to come on line. Iraqi production is currently under a million BPD; when oil starts to flow out of Iraq at up to 4 million BPD, the price will come down sharply and our rate of inflation with it.

SUMMARY AND OUTLOOK

We're faced with a number of important factors that are tending to pull the economy in different directions. The ultimate path will be determined by what combination of forces is dominant. With low inflation and a need for a stronger economy, the Fed is being extremely accommodative. This stimulus will continue to give the economy a big push forward. Iraq looms large because of the expense, contributing to the expanding budget deficit, and the negative influence on sentiment caused by the daily US casualties with no clear resolution in sight. Carrying on a war and creating a big budget deficit carries with it the risk of inflation, as we saw in the late 1960s with the Vietnam War. Rapidly improving productivity and migration of jobs offshore are both deflationary. These are negative influences in current conditions, but if our economy really gets rolling again, they will become positive, restraining inflation. The Bush administration has been encouraging a cheaper dollar, which will help sell our products overseas and reduce our negative balance of trade. We've already seen some increases in commodity prices as a result of the weaker dollar. Japan is reported to have spent an astronomical $40.6 billion in the foreign exchange market in September alone to stop the rise of the Yen, countering the fall of the dollar. Meanwhile, our administration is upbraiding China because it won't increase the value of its currency in order to lower our trade deficit. Over the next six months, the Fed's stimulative policy should dominate by producing a stronger economy with little additional inflation. Interest rates should stay close to where they are now. If Iraqi oil comes on line as expected, it will cause oil prices to fall, restraining inflation and allowing more Fed stimulus. Finally, the key to a full and lasting economic recovery is to have jobs being created steadily in this country.

MARKET AND ECONOMIC STATISTICS

as of Market Close September 30, 2003, with 3-month and 12-month changes

LABOR – Sept '03		3 mo	12 mo
Unemployment Rate	6.1%	–0.3%	0.4%
New Non-Farm Jobs	+57K	–41K	–427K
Avg Hourly Wages	15.45	0.5%	2.7%
Avg Init Unempl Clms	403.5K	–22K	–13K

STOCK INDICES*		3 mo	12 mo
Dow Industrials	9275	3.2%	22.2%
S&P 500	996	2.2%	22.2%
NASDAQ Comp	1787	10.1%	52.5%
NASDAQ 100	1304	8.5%	56.6%
NYSE Comp	5644	2.5%	19.8%
Wilshire 5000	9650	3.3%	24.1%
Russell 2000	488	8.8%	34.6%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	0.94%	9.3%	–41.6%
30-yr T-Bond Yld	4.88%	7.3%	4.3%
FNMA 30yr mortg	5.46%	8.5%	–4.4%
Prime Rate	4.00%	0.0%	–15.8%
Fed Funds Trgt	1.00%	0.0%	–42.9%
Fed Disc Rate	0.50%	0.0%	–60.0%
S/L Long T-Bnd Ind	12053	–2.6%	3.4%

PRICES, INFLATION		3 mo	12 mo
CPI, Aug	184.5	0.7%	2.2%
PPI, Aug	143.4	1.1%	3.5%
Gold, cash	385.4	11.2%	19.0%
W Tx Int Cr Oil	29.23	–3.1%	–4.0%
Copper cent/lb	81.30	8.7%	23.2%
CRB Futures Ind	243.7	4.2%	7.6%
CRB Raw Indust	280.6	8.2%	16.6%

MONEY		3 mo	12 mo
M2, Bil Curr$, Aug	6133	2.3%	8.1%
Free Reserves	0.78	–54.0%	–38.0%
Money Mkts-Bil$	2154	–2.9%	–3.0%
US $$$ Index	92.8	–2.0%	–13.1%

INDUSTRY		3 mo	12 mo
ISM Index, Sept	53.7	3.9	3.0
Indus Prod Ind, Aug	110.2	0.3%	1.7%
Cap Utiliz, Aug	74.6%	0.0%	0.5%
Bldg Permits, Aug	1886K	2.8%	1.1%

2nd Qtr. '03	Final	3 mo	12 mo
GDP-Bil$	9629	3.3% apr	2.5%
GDP Deflator	112.2	1.0% apr	1.5%
Empl Cost Index	165.9	0.9%	3.8%
NF Productivity	128.8	6.8% apr	4.1%

MARKET TIMING VIEWPOINT

Recommended Tactical Asset Allocation

Stocks	130%	Δ	0%
Bonds	0%	Δ	0%
Cash	–30%	Δ	0%

Performance Expectation

	September 2004		September 2008	
	Target	Total Return	Target	Total Return
S&P 500	1200	+20%	2200	+120%
NASDAQ	2230	+25%	4500	+150%
30-Yr. T-Bond	5.25%	– 3%	5.0%	+ 25%

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Martin Capital Advisors, LLP, is a registered investment advisor managing private and institutional investment portfolios, mutual funds and hedge funds. Independent CPA performance review available on request.

FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Dell Computer	33.42	6	Intel	27.52	11	Cisco Systems	19.59	16	CitiGroup	45.51
2	Whole Foods Market	55.20	7	Electronic Arts	92.18	12	Texas Instruments	22.80	17	Bear Stearns	74.80
3	Applied Materials	18.13	8	Starbucks	28.80	13	Williams Sonoma	26.98	18	Home Depot	31.85
4	Tiffany	37.33	9	Charles Schwab	11.91	14	Microsoft	27.80	19	LAM Research	22.23
5	Nasdaq 100	32.42	10	SPDR Trust	99.95	15	Oracle Systems	11.25	20	Medtronic	46.92

COMPARISON OF INVESTMENT RESULTS

Performance of Relevant Indexes

	Martin Capital Advisors[1]	Dow Jones Industrial Avg.	S&P 500 Index	NASDAQ[2]	Wilshire 5000 Index	Long-Term T-Bond Index	Money Market Avg. Yld.	Consumer Price Index
1991	+33.9%	+24.5%	+30.6%	+56.9%	+34.2%	+18.5%	+5.2%	+3.1%
1992	+26.8%	+8.0%	+7.7%	+15.5%	+9.0%	+8.0%	+3.3%	+2.9%
1993	+14.5%	+18.1%	+10.0%	+14.8%	+11.3%	+17.3%	+2.7%	+2.7%
1994	–2.1%	+5.9%	+1.3%	–3.2%	–0.1%	–6.9%	+3.8%	+2.7%
1995	+27.5%	+36.9%	+37.6%	+40.0%	+36.5%	+30.7%	+5.5%	+2.5%
1996	+29.4%	+29.1%	+23.0%	+22.7%	+21.2%	–0.8%	+5.0%	+3.3%
1997	+41.4%	+24.9%	+33.4%	+21.6%	+31.3%	+15.1%	+5.1%	+1.7%
1998	+78.8%	+18.1%	+28.7%	+39.6%	+23.4%	+13.5%	+5.0%	+1.5%
1999	+58.2%	+27.2%	+21.0%	+85.6%	+23.6%	–8.7%	+4.9%	+2.6%
2000	–33.0%	–4.9%	–9.1%	–39.3%	–10.9%	+20.1%	+5.8%	+3.2%
2001	–17.4%	–5.4%	–11.9%	–21.2%	–11.0%	+4.6%	+3.8%	+1.9%
2002	–38.3%	–15.1%	–22.1%	–31.5%	–20.9%	+17.2%	+1.1%	+2.3%
2003	+34.5%	+13.1%	+14.7%	+33.8%	+17.1%	+3.4%	+0.5%	+1.7%
Total[3]	+476.7%	+383.0%	+299.6%	+378.1%	+296.0%	+228.5%	+65.1%	+37.6%
Avg.[4]	+14.7%	+13.2%	+11.5%	+13.1%	+11.4%	+9.8%	+4.0%	+2.5%

[1]Total Annual Performance, net of commissions, fees, and expenses, of all Martin Capital Advisors flexible investment portfolios. Audited 1991-99 by Carpenter & Langford, P.C., Certified Public Accountants. [2]Without dividends. [3]Total compounded return, including reinvestment of dividends and interest. [4]1991-2003 annualized return.

IMPORTANT DISCLOSURE NOTICE: Past performance does not guarantee future results. Figures include the reinvestment of all dividends received and reflect cash and cash equivalents. The volatility of the Flexible Portfolios may differ from that of the benchmark. From time to time, portfolio performance may reflect the use of margin investing as well as material investments in bonds or cash. The manager will utilize stocks, bonds and cash in an attempt to enhance returns. The Flexible Portfolio average represents 46 individual portfolios and 49.8% of all funds under management by MCA on 9/30/03. Clients explicitly elect this management style on their personal data form. The Flexible Portfolios are tactical asset allocation investment accounts containing stocks and bonds that are managed with a view toward capital appreciation.

INVESTMENT PHILOSOPHY

Our investment approach recognizes that to achieve long-term, superior performance, there must be an acceptance of some short-term risk. We then consider fundamental and technical factors in determining a prospective investment's risk-reward ratio. We also evaluate social issues, such as environmental policies and employee relations, as part of our investment assessment.

Overall market risk is considered in the timing of investments and implementation of hedging strategies. We seek to maximize portfolio performance and manage volatility by reducing investment exposure during periods of apparent high market risk, while increasing investment commitment during periods of apparent lower risk.