THE COMPASS

April 2005

A Quarterly Newsletter of Martin Capital Advisors, LLP

Fed Tightening Weighs on Stocks; Rates Still Stimulative

April 20, 2005

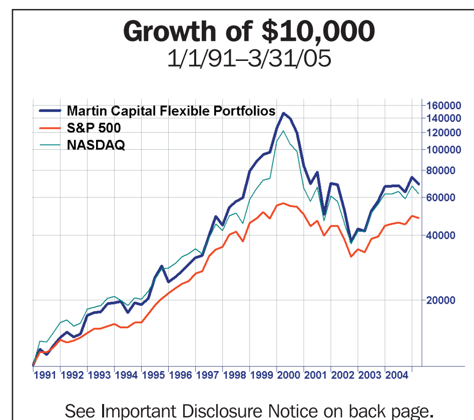
Following a great finish to 2004 stocks reversed direction in the first quarter of 2005, giving back a large chunk of the fourth quarter's gains. Surging energy prices, inflation fears and the uncertainty of how tight the Fed will go seem to be the main culprits responsible for the decline. Interestingly, bonds held their own and managed a slight gain. The bond market is continuing to refuse to sell into the idea that significantly higher inflation is imminent.

As we enter the second quarter the primary question seems to be whether bonds are right or stocks are right about the potential for higher inflation. So far stocks are taking their cue from the Fed and selling into the uncertainty of how high the Fed Funds rate may go in light of the Fed's comments about inflation concerns. Bonds, however, appear to be looking beyond any short-term inflation risks and focusing on the probability that inflation will be contained in the long run. Eventually, either the stock market or the bond market will have to make a major adjustment when it becomes clear whether inflation is a problem or not. I believe that when the issue is resolved the bond market will prove to be right and the stock market will rally on the positive change in sentiment produced by the prospects for sustainable growth with low inflation.

Contrary to popular opinion, the "conundrum," as expressed by Fed Chairman Greenspan, of persistently low bond rates is not a mystery for which there is no answer, but rather the best proof that inflation is not poised to run rampant. Recent Fed comments notwithstanding, the odds are good that in the face of low bond rates the Fed will need to have considerable evidence of higher inflation risks to justify raising Fed Funds above 3.5%. While the latest Consumer Price Index (CPI) came in hotter than expected, the CPI has a history of overstating inflation and Greenspan has acknowledged that he considers the Personal Consumption Expenditures (PCE) rate to be the best inflation gauge. The Fed has an informal target range of 1.5% to 2.0% for the core PCE rate. With the core PCE rate currently at 1.6% the Fed is not likely to aggressively flatten the yield curve to less than a 1% spread between short and long rates without a significant rise in the PCE.

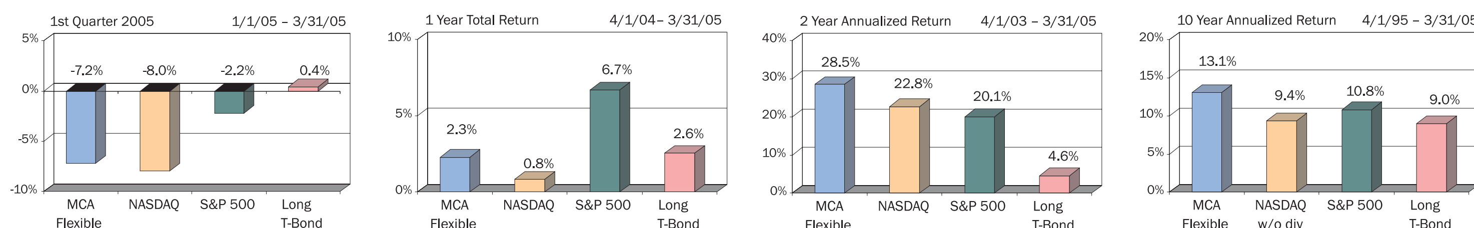
At this point stocks have already priced in the Fed tightening relentlessly until the economy weakens or even goes into a recession. If the bond market is right, then we may be on the verge of a huge stock market advance sometime in the next few months in anticipation of the Fed taking a hiatus in raising rates once they hit the neutral Fed Funds rate of 3.5%. If the bond market is wrong, then bond rates should go up considerably over the next few months. In which case stocks may languish, but probably not drop much further since much of the fear of higher rates is already reflected in current prices. Bottom line: the reward to risk ratio favors stocks over bonds more than it has in many years.

MCA Flexible Portfolios
12-month Tax Efficiency: 91.5%
(After Tax Return divided by Before Tax Return)



INVESTMENT RESULTS

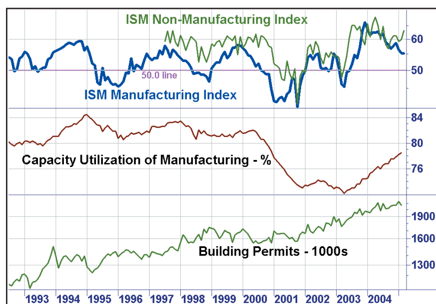
Martin Capital Advisors Flexible Portfolios vs. NASDAQ Composite, the S&P 500 Index and the Lehman Brothers Long Treasury Bond Index



The economy has continued to grow strongly, with annualized 3.8% growth in the fourth quarter of 2004 and 3.9% growth over all of 2004. The first quarter of 2005 may be only slightly weaker, with perhaps 3.5% annualized growth. Industry, both in manufacturing and service, has continued to expand. The first quarter was not good to the stock market, with major stock indexes losing at least small percentages, though none into double digits. If there has been any single factor holding back stock prices, it has been the fear of inflation. Short interest rates have advanced considerably faster than long rates, as the Fed has continued its upward march toward a tighter monetary policy. Prices and inflation have trended up over the past year, though the CPI has risen more slowly in the past quarter. Rising crude oil prices and a falling dollar have contributed to bringing inflation to the forefront of everyone's attention.

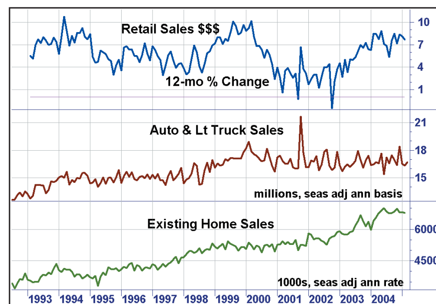
INDUSTRY

The extraordinarily high levels of activity seen last year in manufacturing have waned, though the sector still remains strong by historical standards. The Institute for Supply Management's Manufacturing Index stood at 55.2 for March, considerably above the 50.0 level that separates growth from contraction. Nevertheless, 55.2 is the lowest since September 2003, and far below the December 2003 peak of 66.2. Capacity utilization of manufacturing shows a remarkably straight upward trend on the chart, a clear statement of how that sector is continuing to gain strength. The ISM Non-Manufacturing Index, which covers service industries and therefore represents a far larger portion of our economy than manufacturing, rebounded to 63.1 in March. All nine components of this index were up, with new orders and prices being the strongest. None of the 15 regions surveyed reported any contraction of business.



The construction industry, particularly private housing, continues to grow. It was up 10% last year and, since it represents about 6% of GDP, it boosted GDP by 0.6%. Low mortgage rates have been largely responsible for this rapid growth, as they have made housing affordable for many who otherwise could not have come up with the money for mortgage payments. In addition to homeowner-residents, we have seen large numbers of investors attracted to housing because of the high rates of appreciation in various areas of the country. Home prices have been appreciating at 3% to 4% per month in some areas, though the rate of increase varies a great deal in different parts of the country. The highest rates of increase cannot continue forever and the question of how long they can continue is being debated.

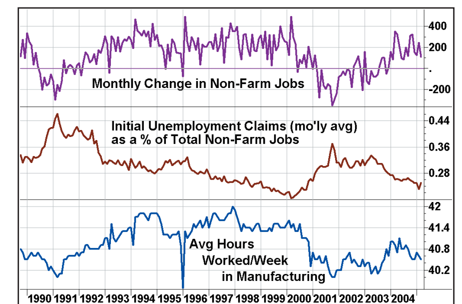
SALES



Total retail sales continued strong through February, up 0.5% for that month and up 7.7% in 12 months. This rate of growth in sales is above that of most of the past decade, important when one considers that two-thirds of our economy depends on consumer spending. Auto and light truck sales for March rose to an annualized rate of 16.7 million units, about the middle of the relatively narrow range of the past three years. Manufacturers' incentives, such as zero-interest loans, have continued to boost vehicle sales considerably. Home sales have been one of the brightest spots in our economy as many consumers have been able to afford homes with low monthly mortgage payments resulting from near record low mortgage rates. The upward trend in the number of sales of existing homes appears to have flattened out at a high level over the past 12 months.

LABOR

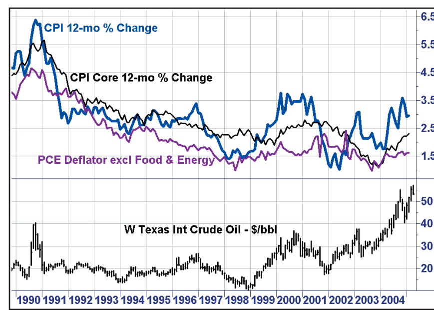
The job market appears strong, though we are still short of the hiring levels seen after other recessions experienced in the past. Only 110,000 net new non-farm jobs were added in March, considerably below the 12-month average of 191,000, which is in turn far below the 300,000 jobs typically added each month following a recession. This apparent lack of strength conflicts with a lot of evidence of stronger growth in manufacturing, services and GDP as a whole. A potential explanation of the conflict may be that increased productivity is eliminating jobs. The gain in productivity during 2004 was 2.8%, seemingly short of the amount necessary to hold down hiring to the degree we have seen. Weekly initial unemployment claims, a leading indicator, have fallen drastically since early 2003, with the monthly average down to a four-year low of 307,000 in February, and back up to 333,000 in March. The chart shows claims as a percentage of jobs to compensate for the increase in the size of the overall job market over time. We are seeing one of the lowest percentages in 15 years. The average number of hours worked per week in manufacturing, another leading indicator, shows a decline over the past year, another bit of data in conflict with the evidence of an expanding manufacturing



sector. Average overtime hours worked per week in manufacturing fell to 4.4, the lowest since late 2003. The total average number of hours worked per week, which includes manufacturing, remained steady at 33.7, roughly the average of the past two years.

INFLATION

A number of measures of inflation are in use, the most prominent of which is the Consumer Price Index. The 12-month change in the CPI was 2.9% in February, considerably below the 3.6% registered last November. The CPI "Core" rate, which excludes the volatile food and energy components, has risen steadily from the low of 1.1% in November 2003 to 2.3% in February, the highest since October 2002. A more obscure inflation indicator is the Core Personal Consumption Expenditure Deflator, which also excludes food and energy. The reason for including this particular deflator is that it is reputed to be the favorite inflation indicator of Fed Chairman Alan Greenspan. This shows an inflation rate of 1.6% through February, reputedly an acceptable number. The "red line" for Chairman Greenspan is reported to be 2.0%. Depending on whether it rises above or below 2.0%, we may be in for a more or less aggressive set of rate hikes than the measured steps we have seen so far.



The primary cause for the upturn in all inflation indicators is the rapidly rising price of crude oil and the secondary cause is the weakness in the US dollar. Oil prices are being pushed up by the demand created in a strong world economy and by uncertainties about supplies from several big producing countries. Venezuela, Nigeria, Russia and the Persian Gulf area all have political or labor problems that might cause supply constraints in the future. No certainty exists about how high oil prices could go over the next few months. Some estimates go to over $100 per barrel, though this extreme seems to be highly unlikely. This uncertainty has pushed up prices considerably more than the real supply-demand situation warrants. On the positive side, the price of crude oil has less than half the influence on our economy today that it did in the early 1970s, when the first big oil price shock hit.

SUMMARY AND OUTLOOK

We are probably going to see at least a couple more quarter-point rate hikes by the Fed in order to get the real Fed Funds target back up to a normal level. The nominal rate is now 2.75%, while the Core PCE Deflator is now 1.6%. Using that deflator as the inflation rate and subtracting it from the nominal Fed Funds target, we get a real Fed Funds target of +1.15%, which is not far below the 2% to 4% range considered normal for a strong economy. This assumes no outbreak of inflation that might be caused by a strong upsurge in oil prices from current levels. Barring disasters, we are unlikely to see $100/barrel oil in the short-term. We have seen industrial raw materials prices rise sharply, influenced a great deal by rapid growth in China. In the longer term, China has problems that will preclude that rate of growth from continuing indefinitely. The banking system there is a mess, with massive loans made to non-productive entities, similar to what occurred in Japan a decade ago, but with more of a political aspect. Furthermore, the rush to industrialize there has led to considerable overbuilding and overcapacity in some areas. It is unlikely that a slowdown will fail to occur over the next couple of years. Such a slowdown should reduce price pressures on raw materials, including crude oil.

MARKET AND ECONOMIC STATISTICS

as of Market Close March 31, 2005, with 3-month and 12-month changes

LABOR – Mar '05		3 mo	12 mo
Unemployment Rate	5.2%	–0.2%	–0.5%
New Non-Farm Jobs	+110K	+477K	+2296K
Avg Hourly Wages	15.95	0.6%	2.6%
Avg Init Unempl Clms	333K	+1.8K	–7.4K

STOCK INDICES*		3 mo	12 mo
Dow Industrials	10504	–2.6%	1.4%
S&P 500	1181	–2.6%	4.8%
NASDAQ Comp	1999	–8.1%	0.3%
NASDAQ 100	1483	–8.5%	3.1%
NYSE Comp	7168	–1.1%	8.6%
Wilshire 5000	11638	–2.8%	5.4%
Russell 2000	615	–5.6%	4.2%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	2.78%	25.2%	195.7%
30-yr T-Bond Yld	4.76%	–1.4%	–0.4%
FNMA 30yr mortg	5.80%	5.5%	5.1%
Prime Rate	5.75%	15.0%	43.8%
Fed Funds Trgt	2.75%	37.5%	175.0%
Fed Disc Rate	2.25%	50.0%	350.0%
S/L Long T-Bnd Ind	12897	0.4%	2.5%

PRICES, INFLATION		3 mo	12 mo
CPI, Feb	192.0	0.4%	2.9%
PPI, Feb	152.5	0.3%	4.6%
Gold, cash	428.6	–2.3%	0.5%
W Tx Int Cr Oil	55.41	27.5%	54.9%
Copper $/lb	1.51	1.6%	11.4%
CRB Futures Ind	313.6	10.5%	10.5%
CRB Raw Indust	335.0	4.2%	5.0%

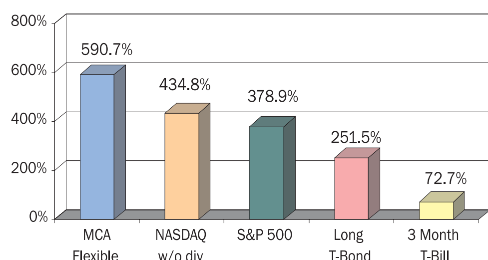
MONEY		3 mo	12 mo
M2, Bil Curr$, Feb	6456	0.8%	5.2%
Free Reserves	1.796	–2.2%	2.3%
Money Mkts-Bil$	1895	–2.9%	–6.4%
US $$$ Index	84.1	4.0%	–3.9%

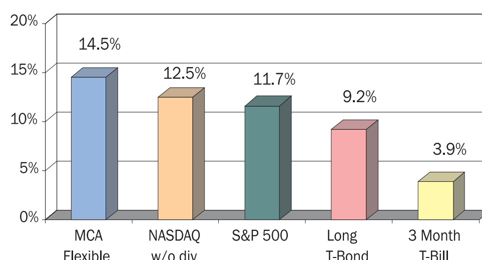
INDUSTRY		3 mo	12 mo
ISM Index, Mar	55.2	–3.4	–7.3
Indus Prod Ind, Feb	118.4	0.3%	1.7%
Cap Utiliz, Feb	79.4%	0.0%	0.5%
Bldg Permits, Feb	2074K	2.8%	1.1%

4th Qtr. '04	Final	3 mo	12 mo
GDP-Bil$	10995	3.8% apr	3.9%
GDP Deflator	109.1	2.3% apr	2.4%
Empl Cost Index	175.2	0.8%	3.7%
NF Productivity	135.0	0.8% apr	2.5%

RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to March 31, 2005





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A Quarterly Publication of
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Martin Capital Advisors, LLP, is a registered investment advisor managing private and institutional investment portfolios. Independent CPA performance review available on request.

FLEXIBLE PORTFOLIO TOP 20 POSITIONS

#	Position	Price	#	Position	Price	#	Position	Price	#	Position	Price
1	Dell Inc	38.42	6	Applied Materials	16.25	11	Charles Schwab	10.51	16	LAM Research	28.86
2	Whole Foods Market	102.13	7	Texas Instruments	25.49	12	Nasdaq 100	36.57	17	Centex	57.27
3	Starbucks	51.66	8	Tiffany	34.52	13	Oracle Systems	12.48	18	S&P Dep Recpts	117.96
4	William Sonoma	36.75	9	Intel	23.23	14	CitiGroup	44.94	19	Bear Stearns	99.90
5	Electronic Arts	51.78	10	Cisco Systems	17.89	15	Home Depot	38.24	20	Sandisk	27.80

COMPARISON OF INVESTMENT RESULTS

Performance of Relevant Indexes

	Martin Capital Advisors[1]	Dow Jones Industrial Avg.	S&P 500	NASDAQ[2]	Dow Jones Wilshire 5000	Long-Term T-Bond	3 Month T-Bill	Consumer Price Index
1991	33.9%	24.5%	30.6%	56.9%	34.2%	18.5%	5.6%	3.1%
1992	26.8%	8.0%	7.7%	15.5%	9.0%	8.0%	3.5%	2.9%
1993	14.5%	18.1%	10.0%	14.8%	11.3%	17.3%	2.9%	2.8%
1994	-2.1%	5.9%	1.3%	-3.2%	-0.1%	-6.9%	3.9%	2.7%
1995	27.5%	36.9%	37.4%	40.0%	36.5%	30.7%	5.6%	2.5%
1996	29.4%	29.1%	23.1%	22.7%	21.2%	-0.8%	5.2%	3.3%
1997	41.4%	24.9%	33.4%	21.6%	31.3%	15.1%	5.3%	1.7%
1998	78.8%	18.1%	28.6%	39.6%	23.4%	13.5%	4.9%	1.6%
1999	58.2%	27.2%	21.0%	85.6%	23.6%	-8.7%	4.7%	2.7%
2000	-33.0%	-4.9%	-9.1%	-39.3%	-10.9%	20.1%	5.9%	3.4%
2001	-17.4%	-5.4%	-11.9%	-21.1%	-11.0%	4.6%	3.8%	1.6%
2002	-38.3%	-15.1%	-22.1%	-31.5%	-20.9%	17.2%	1.7%	2.4%
2003	56.8%	28.3%	28.7%	50.0%	31.63%	2.1%	1.0%	1.9%
2004	10.7%	5.3%	10.9%	8.6%	12.6%	8.0%	1.4%	3.6%
2005	-7.2%	-2.1%	-2.2%	-8.1%	-2.4%	0.4%	0.6%	0.4%
Total[3]	590.7%	464.8%	378.9%	434.8%	389.3%	251.5%	72.7%	43.4%
Avg.[4]	14.5%	12.9%	11.7%	12.5%	11.8%	9.2%	3.9%	2.6%

[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]1991-2005 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 38 individual portfolios and 42.0% of all funds under management by MCA on 3/31/05. 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.