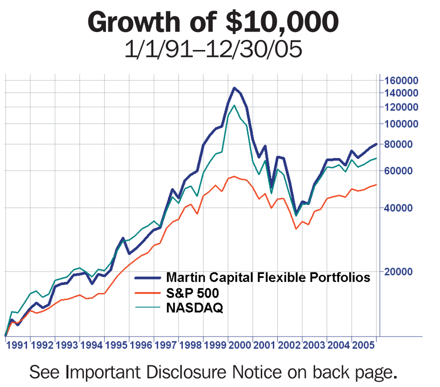
THE COMPASS

January 2006

A Quarterly Newsletter of Martin Capital Advisors, LLP

Stock and Bond Markets Resilient in the Face of Fed Tightening and Higher Energy Prices



January 18, 2006

The financial markets weathered persistent Fed Funds rate increases and higher energy prices to finish the year with positive returns. Since the rise in Fed Funds started from an extremely accommodative base and had only reached a neutral range by the end of the year, stocks and bonds were able to withstand higher energy prices and achieve positive returns with the support of moderate core inflation, reasonable valuations and abundant liquidity.

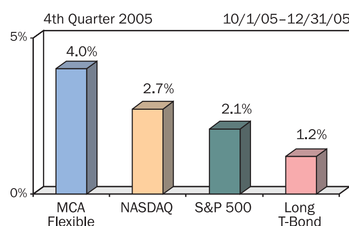
Monetary policy and energy prices may have a greater impact on the direction of stock and bond prices in 2006. If monetary policy becomes restrictive and energy prices surge higher, then the financial markets will probably decline, with the severity of the decline being directly proportional to the amount and duration of monetary restriction and the rise in energy prices. Conversely, if the Fed maintains a neutral monetary policy and energy prices stabilize or decline, then the financial markets have the potential to do quite well. My guess is that the latter scenario is the mostly likely to occur; however, the pending 91-day T-Bill to 10-year T-Note inversion may warrant at least a short-term reduction in equity exposure. Of course, there is also the possibility that the Fed Funds rate could continue to rise as energy prices fall, or vice versa, in which case the financial markets and the economy might not react much either way.

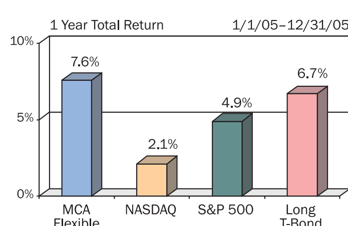
While higher energy prices are clearly bad for the economy and the financial markets, the point at which monetary policy becomes too restrictive is subject to debate. In the past, the slope of the yield curve has been one of the best indicators of monetary accommodation and restraint. Generally, the steeper the yield curve, the more monetary policy is considered to be accommodative. A flat or inverted yield curve implies monetary restraint. The yield curve is currently flat and on the verge of inversion. This should be monitored closely and defensive measures should be seriously considered. Historically, however, it has taken an inversion lasting more than a few months and greater than fifty basis points to have a severe impact on the economy and the stock market. If this happens, then defensive measures should be taken, but it probably would be a mistake to take preemptory action before then, since the end of Fed tightening and the resumption of a normal yield curve would be a positive catalyst for stocks and possibly bonds as well.

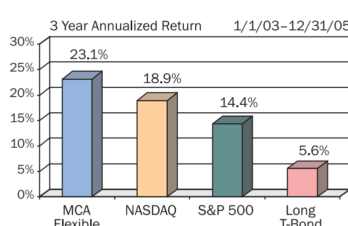
MCA Flexible Portfolios
12-month Tax Efficiency: 91.5%
(After Tax Return divided by Before Tax Return)

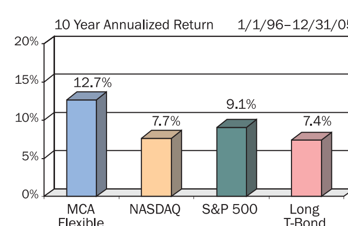
INVESTMENT RESULTS

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







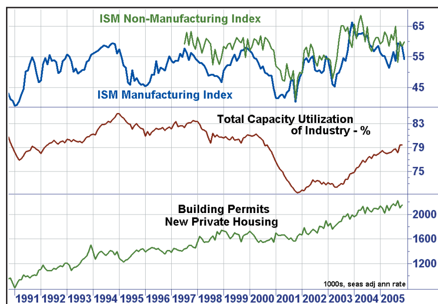


See Important Disclosure Notice on back page.

The economy grew at a rapid annualized rate of 4.1% in the 3rd quarter. Then, after dealing with the aftermath of two tremendously destructive hurricanes, the economy put on an impressive performance in the 4th quarter, growing at roughly a 3.0% rate. The major stock indexes did little more than tread water in the 4th quarter, with increases in a narrow range between 0.8% and 2.7%. The treasury yield curve flattened during the last quarter, as the Fed raised short rates half a percent, while long rates were little changed. We saw a sharp pulse of inflation due to spiking oil prices, which have backed off as production in the Gulf resumed after the hurricanes. Looking ahead, as yet unspent government funds tagged for Gulf Coast repairs mean that a vast amount of money will act as a stimulus to the economy early next year.

INDUSTRY

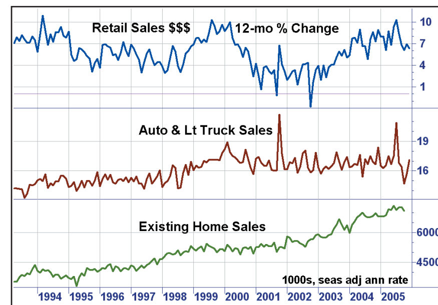
The manufacturing sector of our economy remained strong in the last quarter. The Institute for Supply Management's Manufacturing Index stood at 54.2 in December, down from 58.3 in November. Most of the 10 components backed off only slightly, with Prices Paid down the most, perhaps a good sign for diminishing inflation. The ISM Non-Manufacturing or Services Index rose slightly to a strong 59.8, as most components registered an increase, though here, too, Prices Paid backed off markedly. The Services Index is a far more important indicator because services make up about five times more of our economy than manufacturing. Total capacity utilization of industry in November rose 0.4% to 80.2%. Capacity utilization of manufacturing, however, remained unchanged at 79.4%. Total factory orders rose 2.5% in November, a good sign for the coming months. Durable goods orders were up 4.0%, with non-defense aircraft mostly responsible for the gain.



Building permits and housing starts remained near record highs in November, with seasonally adjusted, annualized figures of 2.155M and 2.123M, respectively. The strong housing industry has benefited tremendously from low mortgage rates, which are not far from the year's highs at about 6.0%. A "pop" for the housing industry "bubble" has been predicted for a couple of years, but in spite of the negative prognostications, it has yet to happen. As long as rates stay near 6%, homebuilding may level off, but we're unlikely to see any major slowdown.

SALES

As consumer spending makes up about two-thirds of our economy, it's clear that consumers have had a big positive effect on our economy over the past two years. Total retail sales were up 0.3% in November and 6.5% over 12 months. Sales were reportedly strong over the holiday season that followed, especially for autos and online retailers, so this positive trend should continue. Auto and light truck sales make up about 23% of total retail sales. After a huge spike in July to a seasonally adjusted, annualized rate of 20.9 million units, which resulted from extraordinarily generous manufacturers' incentives, auto and light truck sales fell to a low of 14.7 million in October. The recovery started in November, with 15.7 million units and December improved further to 17.1 million. New home sales fell in November to 1.245M from 1.404M on a seasonally adjusted, annualized basis. Existing home sales also fell to 6.970M from 7.090M on a like basis. Some are warning that this drop is the beginning of the end of the strong housing market, but, as stated above, we feel this is unlikely to happen without significantly higher mortgage rates.

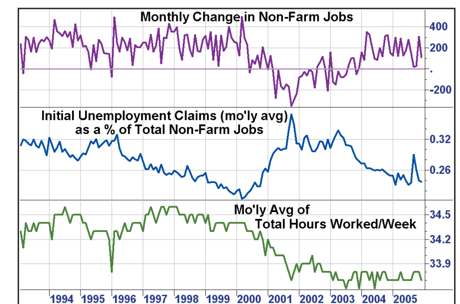


LABOR

Employment figures continue to be both strong and volatile, with 108,000 net new jobs reported in December. Although this was considerably less than the expected 200,000, November's figure was revised up 90,000 to 305,000, giving an average of 207,000 net new jobs for the two months. The aftermath of the hurricanes probably had something to do with the big revision and volatility. In December's net gain of 108,000 were included gains of 96,000 in services, 18,000 in manufacturing and, curiously, a loss of 9,000 in construction, perhaps because of weather. The monthly average of weekly initial unemployment claims, a leading indicator, fell to 319,000, approximately the same as August, just before the hurricanes hit. Average hours worked per week fell to 33.7 from 33.8, where it had stood for the three previous months. Average hours worked in manufacturing, another leading indicator, also fell 0.1 to 40.7. The average of overtime hours per week was 4.5, unchanged from November. The unemployment rate fell to 4.9% in December from 5.0%, though this tends to be a lagging rather than a leading indicator. Average hourly wages rose 0.3% in December, up 3.1% in 12 months. We've seen a more rapid rate of increase in hourly wages following the hurricanes.

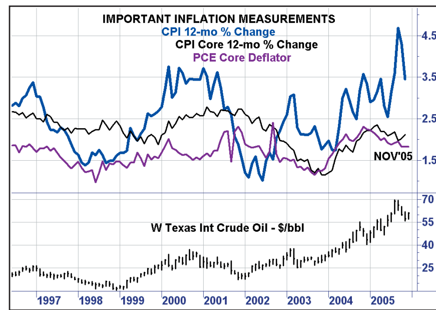
INFLATION

The rate of inflation, always important to the economy and financial markets, is a primary factor today because the Fed is apparently nearing the end of a long series of rate hikes. More



inflation is expected to translate into more rate hikes, less inflation into a nearer end to these increases. The Fed fears, as do many observers of the economy and the markets, that the pulse of inflation caused by higher oil prices will leak over into the rest of the economy. Another concern is that wages may also rise with the need for more workers in rebuilding the Gulf Coast Region.

The top chart shows three different measures of inflation based on the CPI, the CPI Core, and the Personal Consumption Expenditures Core Deflator. After the spike in oil prices, the overall rate of inflation measured by the CPI increased dramatically to 4.7% in September, then dropped back to 3.5% in November. The CPI was up 1.2% in September alone. In contrast, it dropped 0.6% in November, after much of the Gulf Coast oil production was restored and oil prices fell. The CPI Core, which excludes food and energy components, was up 2.1% in 12 months, after a general decline over 2005, and up only 0.1% above the September low. The PCE Core Deflator takes into account the rate of inflation in items consumers buy for their personal use, excluding food and energy. It is reportedly watched by the Fed as the most meaningful barometer of inflation in our economy. The downward trend of inflation measured by this indicator is helpful for the prospects of a near end to rate hikes, as November's



reading fell to 1.8%, the lowest since March 2004.

As usual, the inflation picture is mixed. Gold prices have risen to near $550/oz, the highest since 1981. Some attribute this to new wealth in Asia being poured into gold jewelry, a traditional investment in India and China. The CRB Raw Industrials Commodity Price Sub-Index is at new highs, propelled by copper and aluminum prices. Nickel is off its highs of early 2005, and scrap steel, obviously a critical industrial material, is down 27% from last April's high. Hourly wages of production workers have been rising more quickly, but the Employment Cost Index has fallen because employee benefits have been cut.

SUMMARY AND OUTLOOK

The economy has grown strongly over the past year, with prospects for more of the same over at least the next quarter. Growth in early 2006 will be spurred by more government money being spent on the reconstruction of the Gulf Coast. The Fed has made 13 quarter-point rate increases, starting with Fed Funds at 1.00% in July 2004, rising to 4.25% at present. We've seen hardly any reaction in the economy, though there's usually a lag of 12 to 18 months before the effects of rate increases become apparent. Later in 2006, we may see a somewhat slower economy as the higher rates bite in. Many are wary of the Treasury yield curve becoming inverted, which occurs when short interest rates rise above long rates. Long rates are normally higher because of the additional risk associated with holding an investment for a longer period of time. When short rates are higher than long rates, it's usually because the Fed has raised rates pretty drastically in order to slow an economy that's growing too fast, generating inflation. Five of the last seven recessions have been preceded by such a condition. Factors that are different this time that could help avert a recession are a low core rate of inflation and relatively low yields on long treasuries. Strong purchases by overseas investors are raising prices of US Treasury debt, which is the safest investment around the world that will produce a reasonable return. Consequently, a lot of money, particularly from Asia, is flowing into treasuries. The Fed is aware, however, that an inverted yield curve has been closely connected with recessions in the past and might want to avoid treading on thin ice.

MARKET AND ECONOMIC STATISTICS

as of Market CloseDecember 30, 2005, with 3-month and 12-month changes

3rd Qtr. '05	Final	3 mo	12 mo
GDP-Bil$	11202	4.1% apr	3.6%
GDP Deflator	112.5	3.3% apr	2.8%
Empl Cost Index	179.4	0.8%	3.0%
NF Productivity	136.8	4.7% apr	3.1%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	10718	1.4%	–0.6%
S&P 500	1248	1.6%	3.0%
NASDAQ Comp	2205	2.5%	1.4%
NASDAQ 100	1645	2.7%	1.5%
NYSE Comp	7754	1.6%	7.0%
Wilshire 5000	12518	1.9%	4.6%
Russell 2000	673	0.8%	3.3%

*excluding dividends

INTEREST RATES		3 mo	12 mo
91-day T-Bill DR	4.07%	14.3%	83.3%
30-yr T-Bond Yld	4.61%	0.9%	–4.6%
FNMA 30yr mortg	6.09%	4.1%	10.8%
Prime Rate	7.25%	7.4%	45.0%
Fed Funds Trgt	4.25%	13.3%	112.5%
Fed Disc Rate	3.75%	15.4%	150.0%
S/L Long T-Bnd Ind	13710	1.2%	6.7%

PRICES, INFLATION		3 mo	12 mo
CPI, Nov	197.8	0.9%	3.5%
PPI, Nov	158.9	1.7%	4.5%
Gold, cash	517.0	10.2%	17.9%
W Tx Int Cr Oil	61.04	–7.9%	40.5%
Copper $/lb	2.16	20.0%	45.4%
CRB Futures Ind	331.8	–0.3%	16.9%
CRB Raw Indust	354.1	7.9%	10.1%

MONEY		3 mo	12 mo
M2, Bil Curr$, Nov	6653	1.5%	3.8%
Free Reserves	1.487	–23.4%	–19.0%
Money Mkts-Bil$	2057	5.8%	5.4%
US $$$ Index	91.2	1.9%	12.7%

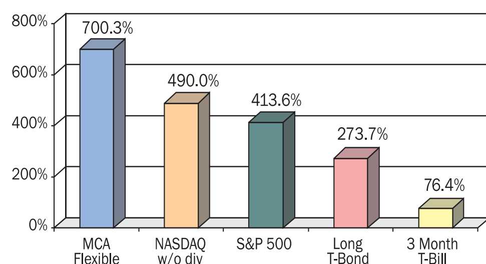
INDUSTRY		3 mo	12 mo
ISM Manuf, Dec	54.2	–5.2	–4.4
ISM Non-Manuf, Dec	59.8	6.5	–1.5
Cap Utiliz, Nov	80.2%	–0.1%	0.9%
Bldg Permits, Nov	2155K	0.8%	3.0%

LABOR – Dec '05		3 mo	12 mo
Unemployment Rate	4.9%	–0.2%	–0.5%
New Non-Farm Jobs	+108K	+514K	+2019K
Avg Hourly Wages	16.34	0.9%	3.1%
Avg Init Unempl Clms	319K	–85.9K	–12.4K

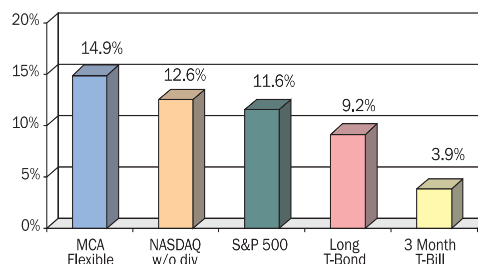
RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to December 30, 2005

Total Return



Annualized Return



THE COMPASS
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FLEXIBLE PORTFOLIO TOP 20 POSITIONS

1	Whole Foods Market	77.39	6	Sandisk	62.82	11	Centex	71.49	16	Nasdaq 100	40.41
2	Dell Inc	29.95	7	Tiffany	38.29	12	Intel	24.96	17	Cisco Systems	17.12
3	Starbucks	30.01	8	Applied Materials	17.94	13	LAM Research	35.68	18	CitiGroup	48.53
4	Williams-Sonoma	43.15	9	Charles Schwab	14.67	14	Advanced Micro Dev	30.60	19	Home Depot	40.48
5	Texas Instruments	32.07	10	Electronic Arts	52.31	15	Red Hat	27.26	20	Bear Stearns	115.53

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%	7.3%	7.7%	15.5%	9.0%	8.0%	3.5%	2.9%
1993	14.5%	17.0%	10.0%	14.8%	11.3%	17.3%	2.9%	2.8%
1994	-2.1%	5.0%	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%	28.7%	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%	-15.0%	-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	7.6%	1.7%	4.9%	1.4%	6.3%	6.7%	3.0%	3.5%
Total[3]	700.8%	485.9%	413.6%	490.0%	433.0%	273.7%	76.4%	47.7%
Avg.[4]	14.9%	12.5%	11.6%	12.6%	11.8%	9.2%	3.9%	2.7%

[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 34 individual portfolios and 38.5% of all funds under management by MCA on 12/30/05. 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.