THE COMPASS

July 2007

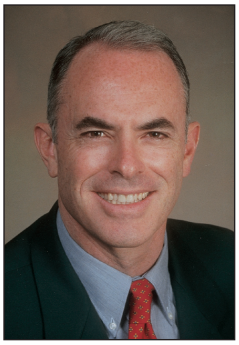
A Quarterly Newsletter of Martin Capital Advisors, LLP

## INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

# Stocks Rise and Bonds Decline in Anticipation of Economic Rebound

*July 23, 2007*

Stocks rallied in the second quarter as signs of an economic rebound from first quarter weakness buoyed expectations for better earnings later this year. Although the Personal Consumption Expenditures (PCE) core inflation rate dropped back to 1.9%, just inside of the Federal Reserve's "comfort zone" of 1% to 2%, Treasury Bond prices fell 2%, in part due to fears that resurging economic strength may eventually result in higher inflation. This divergence between stock and bond performance probably will continue as the economy returns to a normal rate of growth of around 3%.



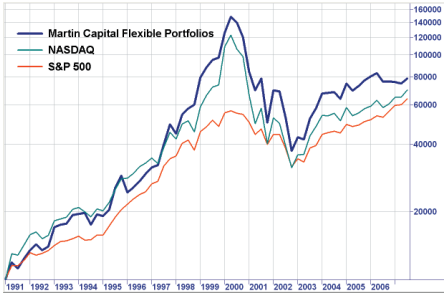
At this point, the U.S. Economy has largely adjusted to the Federal Reserve's tightening cycle, which raised Fed Funds from 1% to 5.25%. After weathering a mild contraction induced by higher interest rates, the economy is entering an expansion phase that should last at least into next year. Of course, further Fed tightening could throw a wrench in the nascent economic expansion, but in light of recent evidence of moderating inflation, such as the drop in PCE core inflation mentioned before, it seems unlikely that the Federal Reserve would raise rates just because the economy is recovering.

The global economy seems to have played the role of a white knight in reducing the negative effect of monetary tightening. Essentially, the strength of the global economy supported the U.S. economy through the recently completed contraction, thus avoiding more severe weakness or recession. The global economy has also had a positive influence in containing core inflation, primarily through lower labor and production costs of goods and services and international competition for sales. Global economic strength has contributed to higher energy and commodity costs, however, but these costs have not had a significant impact on core inflation due to the aforementioned disinflationary factors.

While there are many potentially negative issues that could disrupt the global economy and the U.S. economy, these issues are already reflected to a large degree in the current prices of stocks and bonds. A historically high level of liquidity is the byproduct of the apprehension and nervousness exhibited by financial markets over the last seven years. This liquidity provides a cushion for future disruptions and the fuel for ultimately higher stock prices.

**MCA Flexible Portfolios**
**12-month Tax Efficiency: 99.0%**
(After Tax Return divided by Before Tax Return)

**Growth of $10,000**
1/1/91–6/30/07

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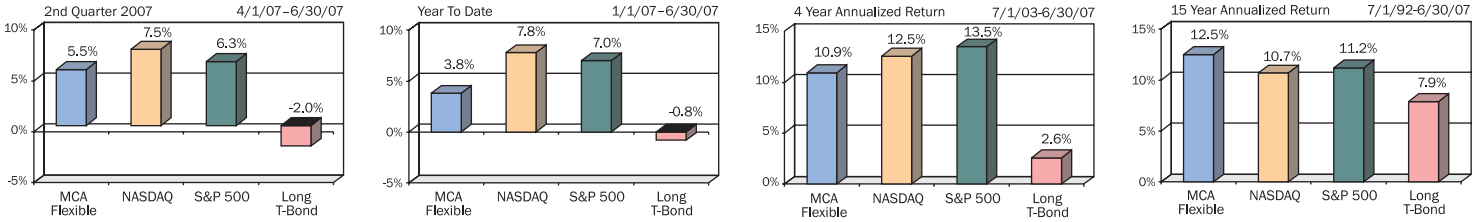
## INVESTMENT RESULTS

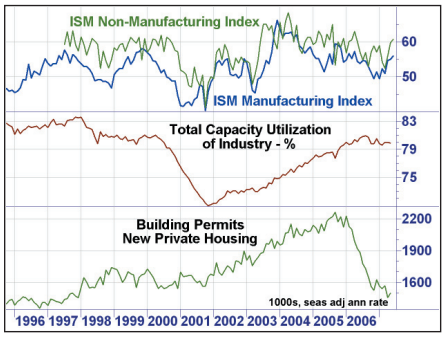
Martin Capital Advisors Flexible Portfolios vs. NASDAQ Composite, the S&P 500 Index and the Lehman Brothers Long Treasury Bond Index




See Important Disclosure Notice on back page.

The first quarter of 2007 saw US economic growth decelerate from an annualized rate of 2.5% to 0.7%, with 1.9% growth over 12 months. The quarter just finished will probably show a stronger growth rate of around 2.5%, as some improvement is apparent in manufacturing and sales. All major stock indexes show single digit increases in the second quarter, with 15% to 20% growth over 12 months. Interest rates, both long and short, showed little change in the last quarter and over 12 months. Industry, excluding housing, showed little strength. Housing continued to decline, though not as steeply as last year. Sales overall were increasing in strength, though weak in vehicles and housing. Inflation was up in the quarter, propelled by high oil prices; however, core inflation declined.

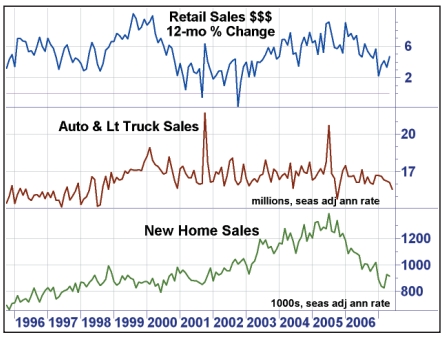
## INDUSTRY




Despite the lackluster performance of the industrial sector over the past several quarters, some bright spots have appeared. The ISM Manufacturing Index has risen from a below-par 49.3 in January to 56.0 in June. The strongest of its 10 components in June was production, which was growing strongly at 62.9. The ISM Non-Manufacturing or Services Index has also risen off its low of 52.4 in March to 60.7 in June, the highest in 14 months; however, the inflation gauge, or "prices paid," was the strongest component of this index. Capacity utilization has been flat to slightly down over the last 12 months. Total factory orders, always volatile, were up a total of 5.1% from February through April, then fell 0.5% in May. Factory orders were down 0.1% in 12 months. The most accurate picture of conditions in industry outside of construction is most likely that shown by capacity utilization, pointing to a slight weakness overall. The ISM Indexes, however, are relatively dependable and may point to a brighter future over the next few months.

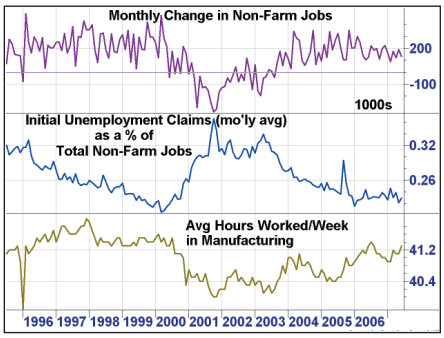
The construction industry has suffered greatly in the past year, with home building being the focus of misery. Homes have not been selling well, which has backed up builders' inventories and slowed construction. There were 1.501M building permits issued in May, a figure 21.7% below that of a year earlier. Housing starts show almost the same pattern, with 1.474M in May, down 24.2% from a year earlier.

## SALES




Total retail sales appear to be strengthening. May sales were up 1.4% for the month and up 4.7% in 12 months. The chart of the 12-month change shows a considerable improvement from the 2.2% 12-month change in January. Sales numbers excluding volatile transportation-related items have changed about the same percentages. Auto and truck sales were pretty flat through May, but then fell from 16.1M to 15.6M units (annualized) in June, the lowest in 20 months. Sales of both new and existing homes have fallen sharply from the highs of the summer of 2005, 34.1% and 16.9%, respectively, through May. Nationwide average home prices are down, as well as numbers of sales. Several factors have been responsible for the sharp decline. Rapid price increases occurred in many areas, particularly along the east and west coasts, so something of a price bubble had formed, which has apparently burst. Many homes in those areas were bought for speculative purposes rather than for use as residences. Low interest rates helped get this going, but extremely loose lending practices fuelled the fire. Sub-prime lending furnished 100% financing with very low rates for the first few years, making it possible for people with shaky credit to get loans to buy houses they really could not afford. Now the low introductory rates have kicked up to the market and owners can't make the payments. Finally, another factor at work is higher mortgage rates, which have made it harder for new buyers to qualify for loans.

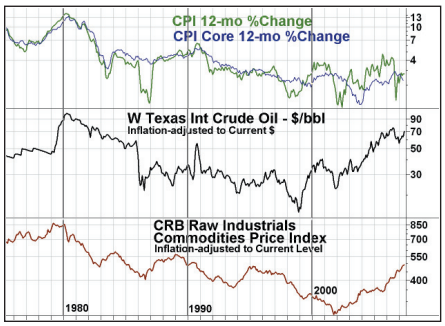
## LABOR




The labor market appears stable and fairly strong, with net new jobs up 132,000 in June, and initial unemployment claims averaging 317,000 for the month. We've seen both continuing gains in jobs and initial claims relatively steady for over a year at levels indicating good job growth. The chart shows initial claims as a percentage of total jobs in order to subtract the effects of the growth of the labor market over time. The average number of hours worked per week was 33.9, equal to the most since June 2002. The data indicating increasing strength were the average weekly hours worked in manufacturing, which were back up to 41.3 from 40.9 early this year. Average weekly overtime hours were also strong at 4.3. Also reflecting a strong labor market was an increase of 0.3% in hourly wages, which were up 4.1% in 12 months. This last is not particularly good news for inflation, as

two-thirds of inflation is said to come from labor costs.

## INFLATION




As inflation is said to be a threat to our economic stability, some perspective is needed. The chart tracks inflation over the past 32 years, with the Consumer Price Index and the Core rates of inflation on top. The peak in inflation in the CPI Core rate, which excludes food and energy, was reached in 1980. Then a long, uneven decline lasted until late 2003, when it bottomed at 1.2%. By November 2004, it had risen to more than 2.0%, which the Fed considers to be the danger point. Using this 2% standard, only 30 months out of more than 32 years had a core inflation rate that was not dangerous. The average Core CPI rate of inflation over the last 50 years is 3.6%, near double the danger point. Yet our economy has somehow survived and prospered under these conditions.

The rise in crude oil prices boosted the 12-month changes in the CPI and the Core rate to 2.7% and 2.3%, respectively, for May. Even though oil is slightly cheaper today than a year ago, the inflation caused by high oil prices seems to have "leaked out" into much of our economy. The middle portion of the chart shows the price of oil adjusted for inflation, illustrating that today's price has still not reached the inflation-adjusted peak of 1980, or even that of a year ago. Thirty years ago, an increase of more than four times in the price of oil, such as we have seen since 2002, would have been a disaster for the overall economy. We are fortunate that our economy is far less dependent on oil today because energy-intensive manufacturing now makes up a much smaller part of the economy than it used to. The bottom portion of the chart shows the inflation-adjusted CRB Raw Industrials Index, which reflects prices of a market basket of commodity prices used in industry. It's interesting to note that the low point wasn't reached until late 2001. While we've seen a sharp rise since that time, it has just barely exceeded the inflation-adjusted peak of 1995.

## SUMMARY AND OUTLOOK

A year has passed since the last Fed rate hike, so the slowing effect of those rate increases on our economy are fading now. Unfortunately, just as the effects of higher rates are easing, the price of crude oil has run up again, producing another headwind for our economy. Consumers have to pay more for gasoline and other forms of energy, making them less able to make other purchases, so this acts like a giant tax. Even though our economy is less in the grip of oil prices than it used to be, no other commodity comes close to having oil's impact on our economy. Oil prices are not high just because of demand in a strongly growing world economy, but also because of political instability around the world. Iraq is one of the world's biggest potential oil producers, yet its output is below half its capacity. Nigeria is a major oil exporter that's politically a real mess. Venezuela, dominated by Yankee-baiting Hugo Chavez, is trying to use oil as a weapon against us, while managing to wreck his country's production levels at the same time. Russia is using supplies of oil and natural gas more and more as a political lever. Terrorists are targeting big Middle East oil production facilities. It's no wonder that a big risk premium is included in the price of oil. And on the demand side of the equation, China is using more and more oil in its burgeoning economy. The chances are small that any of these price-drivers will be reversed quickly, so we can expect high oil prices to be a continuing drag on our economy. Unfortunately, the inflation produced by expensive oil will keep the Fed from cutting rates, so we'll not get any help from that direction. With all these factors at work, the outlook is for continued sub-normal economic growth.

# MARKET AND ECONOMIC STATISTICS

### as of Market Close June 30, 2007
### with 3-month and 12-month percentage changes

| 1st Qtr. '07 | Final | 3 mo | 12 mo |
|---|---|---|---|
| GDP-Bil$ | 11533 | 0.7% apr | 1.9% |
| GDP Deflator | 118.1 | 4.2% apr | 2.7% |
| Empl Cost Index | 104.2 | 0.8% | 3.5% |
| NF Productivity | 137.6 | 1.0% apr | 1.0% |

| STOCK INDICES* | | 3 mo | 12 mo |
|---|---|---|---|
| Dow Industrials | 13409 | 8.5% | 20.3% |
| S&P 500 | 1503 | 5.8% | 18.4% |
| NASDAQ Comp | 2603 | 7.5% | 19.8% |
| NASDAQ 100 | 1934 | 9.1% | 22.8% |
| NYSE Comp | 9873 | 6.6% | 20.9% |
| Wilshire 5000 | 15211 | 5.6% | 18.4% |
| Russell 2000 | 834 | 4.1% | 15.0% |

*excluding dividends

| INTEREST RATES | | 3 mo | 12 mo |
|---|---|---|---|
| 10-yr T-Note Yld | 5.04% | 0.39% | –0.10% |
| 3-mo T-Bill Rate | 4.82% | –0.21% | –0.17% |
| Trea Spd 10y-3mo | 0.22% | 0.60% | 0.10% |
| Fed Funds Trgt | 5.25% | 0.00% | 0.00% |
| Prime Rate | 8.25% | 0.00% | 0.00% |
| FNMA 30yr mortg | 6.61% | 0.49% | –0.10% |
| S/L Long T-Bnd Ind | 13713 | –1.95% | 6.46% |

| PRICES, INFLATION | | 3 mo | 12 mo |
|---|---|---|---|
| CPI-U, May | 207.4 | 1.7% | 2.7% |
| CPI Core, May | 209.1 | 0.4% | 2.3% |
| PCE Core Defl, May | 113.9 | 0.3% | 1.9% |
| Gold, cash $/tr oz | 649.5 | –2.1% | 5.4% |
| W Tx Int Cr Oil $/bbl | 70.69 | 7.3% | –4.4% |
| Copper, $/lb | 3.45 | 9.9% | 0% |
| CRB Futures Ind | 315.7 | –0.4% | –8.8% |

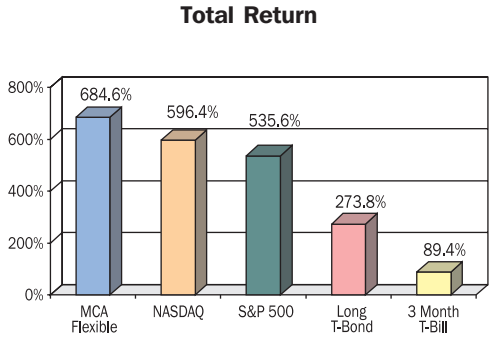
| INDUSTRY | | 3 mo | 12 mo |
|---|---|---|---|
| ISM Manuf Ind, Jun | 56.0 | 5.1 | 2.2 |
| ISM Services, Jun | 60.7 | 8.3 | 3.7 |
| Cap Utiliz, May | 81.3% | –0.3% | –0.4% |
| Bldg Permits, May | 1501K | –2.6% | –21.7% |

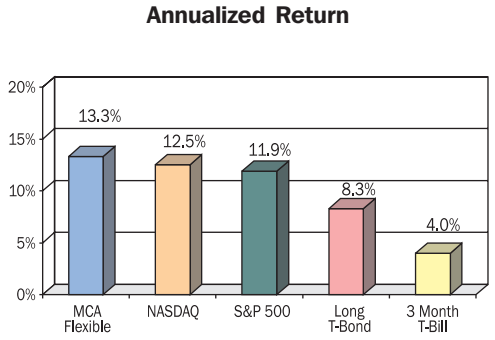
| SALES | | 3 mo | 12 mo |
|---|---|---|---|
| Total Retail-$B, May | 377.9 | 2.4% | 4.7% |
| Ttl ex Autos-$B, May | 299.3 | 2.5% | 4.3% |
| Autos-M Units, Jun | 15.6 | –4.5% | –3.6% |
| New Homes-K, May | 915 | 7.6% | –15.8% |

| LABOR – Jun '07 | | 3 mo | 12 mo |
|---|---|---|---|
| Unemployment Rate | 4.5% | 0.1% | –0.1% |
| New Non-Farm Jobs | 132K | 427K | 2008K |
| Avg Init Unempl Clms | 317K | 0.7K | 7.3K |
| Avg Hourly Wages | 17.38 | 1.0% | 4.1% |

## RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to June 30, 2007





THE COMPASS

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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

as of June 30, 2007

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Apple | 122.04 | 6 | Starbucks | 26.24 | 11 | Tiffany | 53.06 | 16 | MEMC | 61.12 |
| 2 | Whole Foods | 38.30 | 7 | Oracle | 19.71 | 12 | SanDisk | 48.94 | 17 | Advent Software | 32.55 |
| 3 | Texas Instruments | 37.63 | 8 | Williams-Sonoma | 31.58 | 13 | Intel | 23.74 | 18 | OmniVision | 18.11 |
| 4 | Charles Schwab | 20.52 | 9 | LAM Research | 51.40 | 14 | Citigroup | 51.29 | 19 | Applied Materials | 19.87 |
| 5 | Cisco Systems | 27.85 | 10 | Caterpillar | 78.30 | 15 | Dell | 28.55 | 20 | Bear Stearns | 140.00 |

## COMPARISON OF INVESTMENT RESULTS

**Performance of Relevant Indexes**

| | Martin Capital Advisors[1] | Dow Jones Industrial Avg. | S&P 500 | NASDAQ | 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% | 31.6% | 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% |
| 2006 | -5.6% | 19.1% | 15.8% | 9.5% | 15.9% | 0.9% | 4.9% | 2.0% |
| 2007 | 3.8% | 8.8% | 7.0% | 7.8% | 7.6% | -0.8% | 2.5% | 3.1% |
| Total[2] | 684.6% | 658.6% | 535.6% | 596.4% | 564.3% | 273.8% | 89.4% | 55.4% |
| Avg.[3] | 13.3% | 13.1% | 11.9% | 12.5% | 12.2% | 8.3% | 4.0% | 2.7% |

[1]Total Annual Performance, net of commissions, fees, and expenses, of all Martin Capital Advisors flexible investment portfolios. Without dividends. [2]Total compounded return, including reinvestment of dividends and interest. [3]1991-2007 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; however, Nasdaq returns are without dividends. 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 24 individual portfolios and 24.2% of all funds under management by MCA on 6/30/07. 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.