THE COMPASS

January 2008

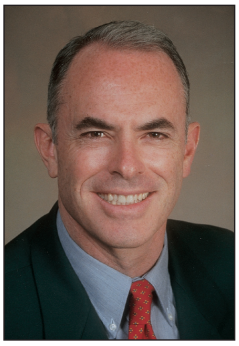
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

As Growth Slows, Fed is Behind the Curve, So Far

January 18, 2008

Stocks declined in the fourth quarter as evidence of slowing growth and concern that the Federal Reserve was not lowering rates fast enough weighed on the markets. Despite high commodity prices and persistent inflation concerns, bonds performed well, apparently anticipating that inflation will eventually come down as the economy weakens.



Unfortunately, the sea change in Fed policy that seemed to have occurred on September 18th when the FOMC surprised the markets with a .5% fed funds cut is now in question. Although Mr. Bernanke continues to talk about aggressively lowering rates, so far the two quarter point cuts since September have not come close to matching his rhetoric.

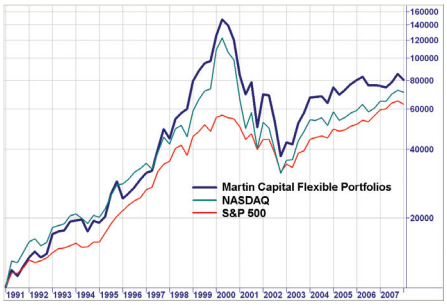
MCA Flexible Portfolios
12-month Tax Efficiency: 99.5%
(After Tax Return divided by Before Tax Return)

At this point, the stock market has gotten off to a weak start for 2008. Widening credit concerns (primarily driven by mortgage defaults and subsequent credit derivative illiquidity) and the aforementioned disappointment that the Fed appears to be behind the curve are continuing to cause uncertainty in the financial markets. Although the markets already reflect much of this uncertainty, it's hard to say when this uncertainty will be resolved. Until greater action is taken to improve market psychology, we may see lower stock market prices; however, market psychology has now become negative enough that there is a high probability that we will see much higher prices from current levels sometime in the next three to six months.

My guess is that global growth and liquidity will get us through the current U.S. economic slowdown without falling into a severe recession. Today, the U.S. is a much smaller portion of the global economic pie than in the past, so our problems should have less of a negative impact on the rest of the world. On the other hand, global strength should have a more positive impact on our economy, and we are seeing that in the solid earnings of U.S. companies with significant overseas business and the liquidity being injected into troubled U.S. companies by foreign investors.

There's an old saying on Wall Street, "Don't fight the Fed." Well, the Fed may be behind the curve, but Chairman Bernanke has made it clear that further interest rate cuts are in the works and that the Fed will do whatever it takes to avoid a recession. Although the financial markets are in doubt, I think the Fed, with the assistance of the global economy, will prevail.

Growth of $10,000
1/1/91–12/31/07



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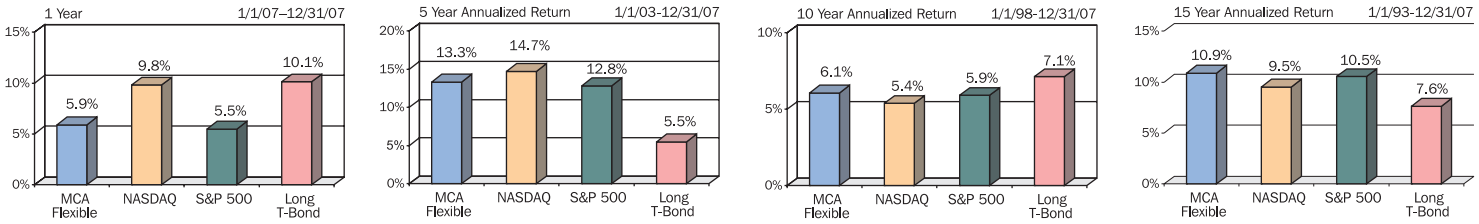
INVESTMENT RESULTS

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



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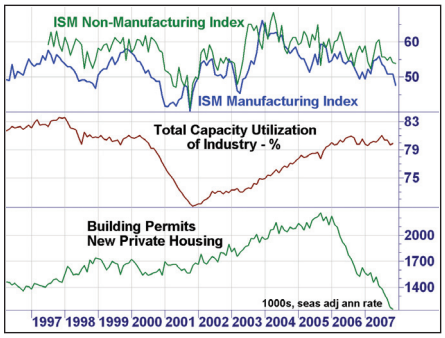
The impact of the complex and far reaching mortgage loan problems hit the economy with full force over the last few months. GDP growth went from an annualized 4.9% in the third quarter down to perhaps between 0.5% and 1.0% in the last quarter. These problems reduced estimates of future corporate earnings, which caused stock prices to fall. No major stock indexes advanced in the quarter, though none declined more than 5%. All indexes rose over 12 months except the Russell 2000 Small Cap Index. Yields on US Treasuries of all maturities have fallen over three and 12 months as the softness in the economy became apparent and problems in the financial sector pushed money toward safer investments. Inflation has accelerated due to the combination of a weak US dollar and much higher oil prices. Considering the extent of oil's price increase, we are fortunate that inflation has not had more of an impact on the economy as a whole.

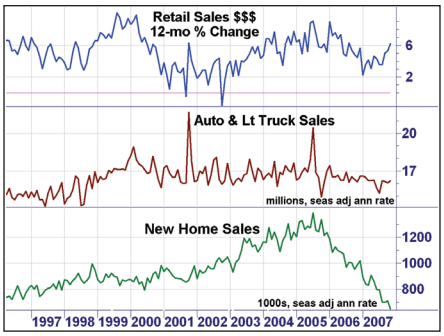
INDUSTRY



Manufacturing has suffered the most in the industrial sector, as the ISM Manufacturing Index fell to 47.7 in December, the lowest such reading since April 2003, and well below the 50.0 mark separating growth from contraction. Total factory orders for November were up 1.5%, while durable goods orders were down 0.1%. Excluding transportation, durables orders were down 0.7% for the month. This relatively large difference resulted from big orders for aircraft and small, non-durable items, while orders for large items except aircraft were down. The ISM Non-Manufacturing or Services Index stood at 53.9 in December, slightly lower than the previous two months, but still relatively strong. As services make up a much larger part of the economy than manufacturing, this strength is good news. Capacity utilization through November has fallen less than one percent from the highs last July in both total capacity and that of manufacturing, more typical of a relatively strong economy.

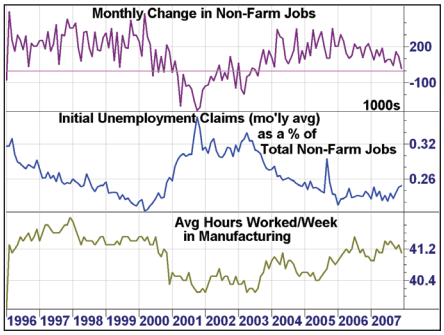
Housing is the weakest sector of industry at this point, as the number of homes being permitted in November was 1.152M on a seasonally adjusted annualized basis. That was down 24.6% in 12 months and the lowest since May 1993. A nationwide bursting housing price bubble combined with severe problems in the mortgage and banking industries have been a powerful one-two hit. Even areas that have not experienced such a huge run-up in prices over the last decade are beginning to suffer as lenders have raised standards for borrowers and tightened terms.

SALES



Retail sales through November continued to be relatively strong, with an increase of 1.4% in the first two months of the quarter. The increase over 12 months through November was 6.2%, though total holiday sales were reportedly up only slightly from 2006. As retail sales include gasoline, we can assume that higher prices for gasoline and other forms of energy took up a larger share of the total than in previous years. Auto and light truck sales annualized 16.1 to 16.2 million units in all three months of the last quarter, essentially equal to the averages for both 2006 and 2007. New homes, which took the biggest hit in sales, were down to an annualized rate of 647,000 in November, the lowest in over 12 years, 34.4% below sales in the same month a year earlier and 53.4% below the peak of 1,389,000 in July 2005. Sales of existing homes have been not quite as terrible, 5.00M in November, down 20.0% from November 2006, and off 32.3% from a high in 2000.

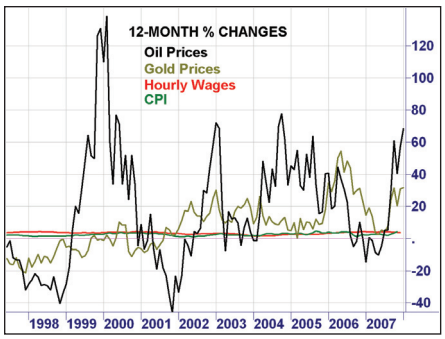
LABOR



December's figures showed clear weakness in the job market: net new non-farm jobs at 18,000, lowest since August 2003, weekly initial unemployment claims up to an average of 343,750, the highest in two years, and the unemployment rate up 0.3% to 5.0%. Some 49,000 jobs were lost in construction and 31,000 in manufacturing, which were offset by a gain of 93,000 in various services. This perfectly fits the pattern of a weak ISM Manufacturing vs. stronger ISM Services Index. Average hours worked per week in manufacturing were 0.3 off the September high at 41.1. The average number of overtime hours worked per week in December fell to 3.9, the lowest since February 2002. Overtime hours are typically a consistent leading indicator of hiring or layoffs, as employers tend to use more overtime before hiring new employees and less overtime before letting them go. The low figure for overtime hours is pointing more toward layoffs than hiring. In profound contrast to these figures and for no apparent reason the Challenger jobs report for December showed only 44,416 corporate layoff announcements, down considerably from 79,459 in August and 73,140 in November.

INFLATION

The overall rate of inflation in our economy, as measured by the Consumer Price Index, rose to 4.7% in 12 months through November. The Core rate,



which excludes volatile food and energy components, was up only 2.3% in that period. The Core PCE Deflator, a measure closely watched by the Fed, was up 2.2%. Unfortunately, the core rates are over the Fed's comfort limit of 2.0%. The chart shows percentage changes over 12 months for oil and gold prices, hourly wages and the CPI. The culprit responsible for our current uncomfortably high rate of inflation is oil. Though the weakness of the US dollar has contributed to higher oil prices, much of the increase has been caused by political instability around the world. This instability may diminish over the next year, which would lessen the pressure on oil prices. Nigeria has calmed after elections, Iran is edging toward détente, albeit with frequent setbacks, and Hugo Chavez can have few surprises left for us. The price of gold is up more because of dollar weakness than anything else. Gold's price tends to be high as a result of inflation rather than as a cause. By comparison with oil and gold prices, wages and the CPI are very stable. Hourly wages were up 3.7% in a year and the inflationary impact of that increase may be offset by increased productivity. Nevertheless, as two-thirds of inflation is said to come from labor costs, this is an important figure.

FINANCIAL SECTOR

The losses in the financial sector caused by the sub-prime mortgage crisis are having a big effect on our economy right now. The institutions hardest hit are banks, investment/brokerage houses and insurance companies. The losses occurred because complex derivatives involving mortgages were packaged and sold to many institutions around the world that did not understand the level of risk involved. Leverage was used with these derivatives in order to enhance the yield and that magnified the losses. Only a small portion of the sub-prime mortgages are likely to default, but because of leverage, losses may equal the total amount of the mortgages, whether defaulting or not. The derivatives were sliced and diced and then resold multiple times, so nobody really knows who holds these debt bombs and how much the total losses will be. Ordinary transactions between banks have become suspect because banks are reluctant to send money to other banks that might suddenly go broke. Without trust between banks, the system is not working as smoothly as it should. With a liquidity crunch developing, the Fed and other central banks have tried to flood the system with money. Riding to the rescue with billions of dollars are funds from Asia and the Middle East, where trade surpluses in dollars have been enormous. Some are sovereign wealth funds owned and operated by governments, others are private. Much of this cash has been invested in US Treasury securities, but a higher return was desired for parts of their portfolios. We are fortunate that this pool of dollars is looking for a home because liquidity problems would be more severe and last longer without it. Nevertheless, this rescue of institutions is not coming cheap for those receiving the cash.

SUMMARY AND OUTLOOK

Our economy is experiencing a slowdown – how much it eventually slows will depend to a great extent on how the mortgage crisis plays out, both in terms of how big losses will be and how much cash is invested in institutions to replace the losses. Most economists expect the bottom to be in the last or the next quarter and for no recession to occur. As the rate of inflation has increased, the Fed has less freedom to drop interest rates, putting it between a rock and a hard place. A lower price for oil would give the Fed more room to maneuver. Most important of all and despite the financial setback in the financial sector, the underpinnings of the US economy remain robust and strong.

MARKET AND ECONOMIC STATISTICS

as of Market Close December 31, 2007
with 3-month and 12-month percentage changes

3rd Qtr. '07	Final	3 mo	12 mo
GDP-Bil$	11659	4.9% apr	2.8%
GDP Deflator	119.8	1.0% apr	2.4%
Empl Cost Index	105.9	0.8%	3.2%
NF Productivity	138.7	6.3% apr	2.7%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	13265	–4.5%	6.4%
S&P 500	1468	–3.8%	3.5%
NASDAQ Comp	2652	–1.8%	9.8%
NASDAQ 100	2085	–0.3%	18.7%
NYSE Comp	9740	–3.0%	6.6%
Wilshire 5000	14820	–3.5%	3.9%
Russell 2000	766	–4.9%	–2.7%

*excluding dividends

INTEREST RATES		3 mo	12 mo
10-yr T-Note Yld	4.03%	–0.55%	–0.67%
3-mo T-Bill Rate	3.23%	–0.57%	–1.76%
Trea Spd 10y-3mo	0.80%	0.02%	1.09%
Fed Funds Trgt	4.25%	–0.50%	–1.00%
Prime Rate	7.25%	–0.50%	–1.00%
FNMA 30yr mortg	6.11%	–0.14%	–0.03%
S/L Long T-Bnd Ind	15226	5.99%	10.12%

PRICES, INFLATION		3 mo	12 mo
CPI-U, Nov	210.6	1.4%	4.3%
CPI Core, Nov	212.6	0.7%	2.3%
PCE Core Defl, Nov	115.5	0.7%	2.2%
Gold, cash $/tr oz	833.6	12.2%	30.9%
W Tx Int Cr Oil $/bbl	96.01	17.6%	57.2%
Copper, $/lb	3.03	–16.5%	6.2%
CRB Futures Ind	358.7	7.5%	16.7%

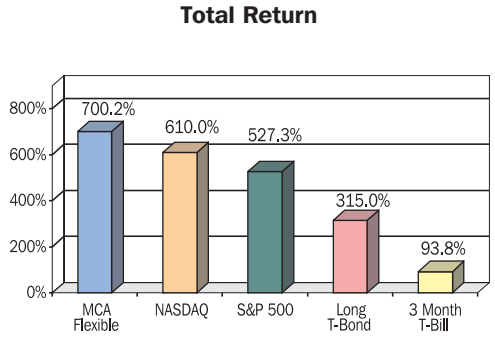
INDUSTRY		3 mo	12 mo
ISM Manuf Ind, Dec	47.7	–4.3	–3.7
ISM Services, Dec	53.9	–0.9	–3.2
Cap Utiliz, Nov	81.5%	–0.5%	0.2%
Bldg Permits, Nov	1152K	–12.9%	–24.6%

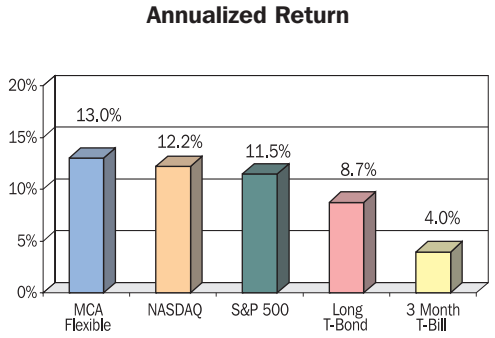
SALES		3 mo	12 mo
Total Retail-$B, Nov	385.8	2.3%	6.2%
Ttl ex Autos-$B, Nov	308.1	2.9%	7.4%
Autos-M Units, Dec	16.1	–0.1%	–2.5%
New Homes, Nov	647K	–7.7%	–34.4%

LABOR – Dec '07		3 mo	12 mo
Unemployment Rate	5.0%	0.3%	0.5%
New Non-Farm Jobs	+18K	+292K	1629K
Avg Init Unempl Clms	343.8K	–6.8K	–2.5K
Avg Hourly Wages	17.71	1.0%	3.7%

RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to December 31, 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 December 31, 2007

1	Apple	198.08	6	Texas Instruments	33.40	11	Starbucks	20.47	16	Bear Stearns	88.25
2	Charles Schwab	25.55	7	Intel	26.66	12	Williams-Sonoma	25.90	17	Boeing	87.46
3	Whole Foods	40.80	8	MEMC	88.49	13	SanDisk	33.17	18	Advent Software	54.10
4	Cisco Systems	27.07	9	Tiffany	46.03	14	Dell	24.51	19	Bank of New York	48.76
5	Oracle	22.58	10	Intuitive Surgical	323.00	15	Applied Materials	17.76	20	LAM Research	43.23

COMPARISON OF INVESTMENT RESULTS

Performance of Relevant Indexes

	Martin Capital Advisors[1]	NASDAQ	S&P 500	Dow Jones Industrial Avg.	Dow Jones Wilshire 5000	Long-Term T-Bond	3 Month T-Bill	Consumer Price Index
1991	33.9%	56.9%	30.6%	24.5%	34.2%	18.5%	5.6%	3.1%
1992	26.8%	15.5%	7.7%	7.3%	9.0%	8.0%	3.5%	2.9%
1993	14.5%	14.8%	10.0%	17.0%	11.3%	17.3%	2.9%	2.8%
1994	-2.1%	-3.2%	1.3%	5.0%	-0.1%	-6.9%	3.9%	2.7%
1995	27.5%	40.0%	37.4%	36.9%	36.5%	30.7%	5.6%	2.5%
1996	29.4%	22.7%	23.1%	28.7%	21.2%	-0.8%	5.2%	3.3%
1997	41.4%	21.6%	33.4%	24.9%	31.3%	15.1%	5.3%	1.7%
1998	78.8%	39.6%	28.6%	18.1%	23.4%	13.5%	4.9%	1.6%
1999	58.2%	85.6%	21.0%	27.2%	23.6%	-8.7%	4.7%	2.7%
2000	-33.0%	-39.3%	-9.1%	-4.9%	-10.9%	20.1%	5.9%	3.4%
2001	-17.4%	-21.1%	-11.9%	-5.4%	-11.0%	4.6%	3.8%	1.6%
2002	-38.3%	-31.5%	-22.1%	-15.0%	-20.9%	17.2%	1.7%	2.4%
2003	56.8%	50.0%	28.7%	28.3%	31.6%	2.1%	1.0%	1.9%
2004	10.7%	8.6%	10.9%	5.3%	12.6%	8.0%	1.4%	3.6%
2005	7.6%	1.4%	4.9%	1.7%	6.3%	6.7%	3.0%	3.5%
2006	-5.6%	9.5%	15.8%	19.1%	15.9%	0.9%	4.9%	2.0%
2007	5.9%	9.8%	5.5%	8.9%	5.7%	10.1%	4.7%	4.3%
Total[2]	700.2%	609.6%	527.3%	659.5%	552.9%	315.0%	93.5%	57.1%
Avg.[3]	13.0%	12.2%	11.5%	12.7%	11.7%	8.7%	4.0%	2.7%

[1]Total annual performance, net of commissions, fees, and expenses of all Martin Capital Advisors' *Flexible Portfolios.*
[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 34 individual portfolios and 39.5% of all funds under management by MCA on 12/31/07. 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.