THE COMPASS

January 2010

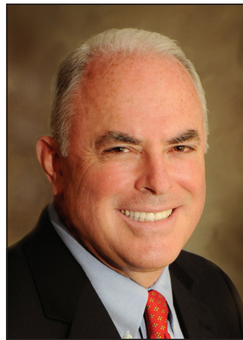
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Stocks Advance and Bonds Falter As Economy Recovers

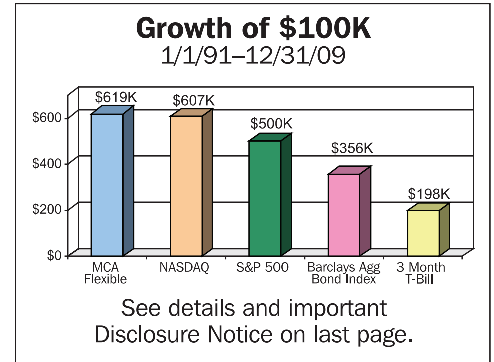
January 26, 2010

Stocks continued to advance in the fourth quarter as GDP turned positive for the first time since the second quarter of 2008 and corporate earnings were much better than expected. In contrast to 2008, most equity indexes finished 2009 with their best performances since 2003. Most fixed income securities did not fare as well, with the risk of higher inflation as the economy recovers beginning to weigh on bond prices. Interestingly, as bond prices have fallen, the yield curve has steepened, presaging an even stronger economy and higher stock prices – especially as long as the Fed remains accommodative, which the Fed chairman has said it will be for quite a while. (By the way, the first interest rate increases by the Fed will not represent a tight monetary policy, rather they will be a confirmation that the economy is well into recovery.)



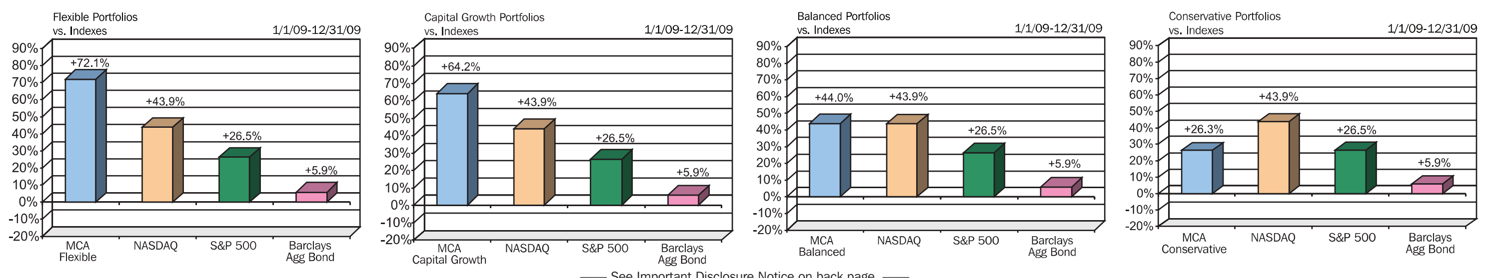
2010 has begun with a mixed performance for the stock market. Although corporate earnings have been quite positive for the most part, concerns about potential policy errors by the president and the Congress have sparked a mild correction as we near the end of the month. The latest pullback may prove to be the long anticipated correction that I mentioned back in October would happen at some point; however, I also pointed out back then that "history shows that it is a big mistake to try to avoid corrections at the expense of participating in the powerful bull markets that unfold from steep recessions." Whether or not the current correction proves to be more severe than the minor corrections we have seen since the bull market began in March, the growing signs of economic expansion and corporate earnings power, which cannot easily be knocked off course, suggest that the bull market still has a long way to go and should resume again in the near future.

There are still many strong winds, such as stubbornly high unemployment, that buffet the economy; however, these negative forces are in a gradual retreat. Just as we sailed into an economic storm in 2007, we are sailing out of the storm now, with almost every economic indicator pointing to calmer seas ahead. As we emerge from the storm, the fear of it overtaking us again is palpable, but the likelihood of that happening is very small, since the former headwinds of unemployment and inventory reductions are now tailwinds driving a surge in productivity and corporate efficiency, resulting in a virtuous cycle of higher corporate earnings and improving economic conditions. Historically, this environment has been extremely good for stocks.



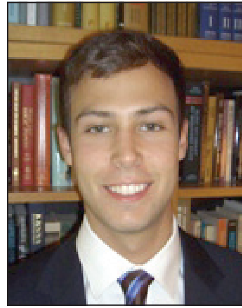
INVESTMENT RESULTS

Martin Capital Advisors' Investment Portfolios vs. NASDAQ Composite, S&P 500 and Barclays Aggregate Bond Indexes



— See Important Disclosure Notice on back page. —

The final annualized GDP number for the third quarter 2009 was 2.2 percent. This was the strongest growth recorded since the third quarter of 2007 and was due to the immense support from government monetary and fiscal policy. There is uncertainty as to how the economy will perform when the policies change and the stimulus runs out; nevertheless, economists' generally predict GDP to be between 3-4 percent in 2010. (Figure 1)



In October, the unemployment rate broke the 10 percent threshold for the first time in 26 years. It peaked at 10.1 percent, but has since stabilized at 10.0 percent in both November and December. There are some signs that unemployment may begin to fall. November was the first month of a positive Non-farm Jobs Report since late 2007. The positive streak did not last long; in December, the economy lost 85,000 jobs. Though December's job number was negative, in December 2008 the economy lost 681,000 jobs. The significant drop in the number of monthly job losses and the rapid fall of initial unemployment claims are why many economists' believe the unemployment rate has peaked. (Figures 2, 3 and 4)

The housing sector, which was primarily responsible for the recession, is now recovering. Existing home sales skyrocketed in October and November, as the first-time homebuyer tax credit was extended and expanded. Home sales were 6.5 million in November – a huge improvement from their low of 4.4 million in January 2009. Low mortgage rates are contributing to the recovery in the housing market: the 30-year conforming mortgage rate is the lowest in recorded history (San Francisco Fed). Housing starts and permits issued are leveling out, but are still way down from their highs. (Figures 5, 6)

Household consumption has been a strong force behind the recovery. Personal consumption expenditures have risen 2.6 percent since May 2009. Retail sales have rebounded well in comparison to what they were a year ago; however, in December Retail Sales declined 0.3 percent when the market expected a 0.5 percent increase. Auto sales, another indicator of household consumption, continue to be strong despite earlier fears that the Cash-For-Clunkers program would hurt future demand for automobiles. (Figures 7, 8)

Manufacturing, which was the first sector to show signs of recovery, is continuing to expand. In December, the ISM Manufacturing Index was 55.9 – one of the strongest recordings in a decade. The ISM Non-Manufacturing Index was 50.1 in December signifying a small expansion. (Figure 9)

Inflationary pressures continue to be low. In 2009, consumer prices rose by 2.7 percent due to higher energy costs. Core CPI, which excludes food and energy, was up 1.8 percent, matching the rise in 2008. (Figure 10)

The Treasury Yield Curve remains positively sloped, reflecting the Fed's extremely accommodative policy. The large spread between short and long terms rates signals strong economic expansion for at least the next several years. (Figure 11)

Figure 1

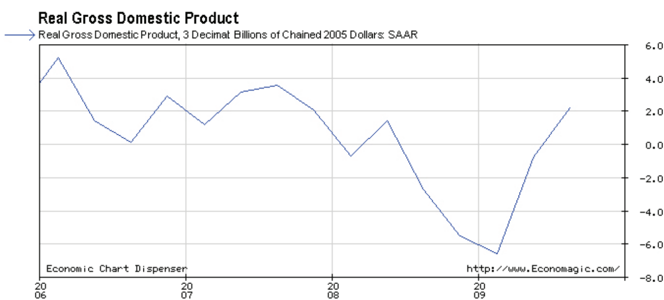


Figure 2

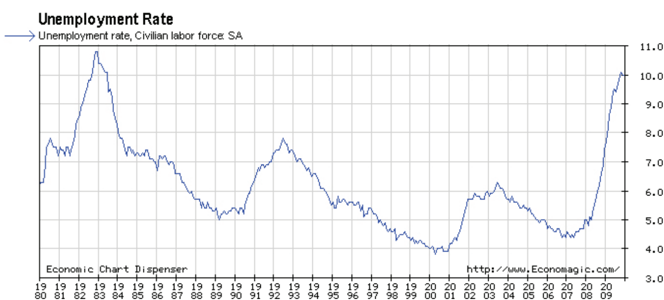


Figure 3

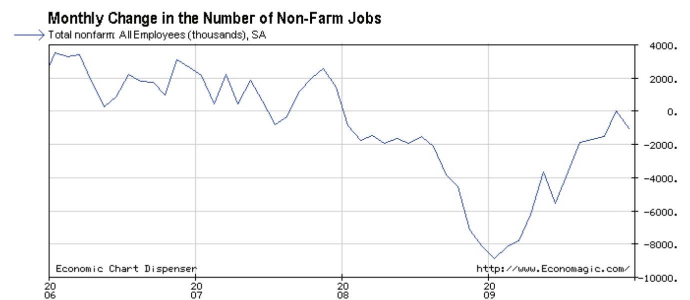


Figure 4

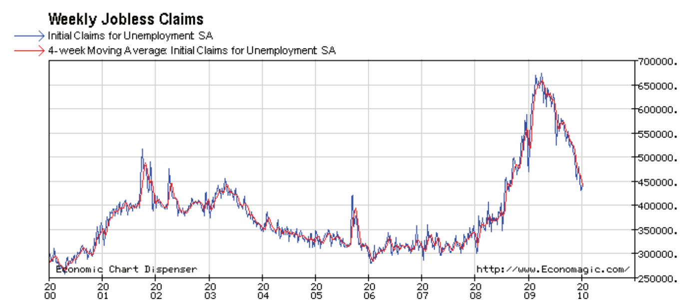


Figure 5

Figure 6

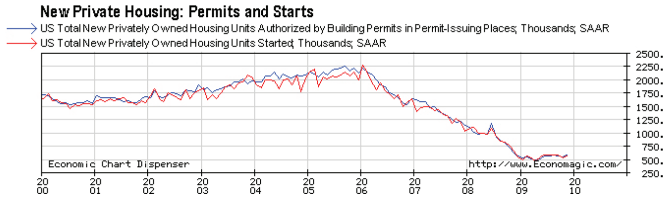


Figure 7

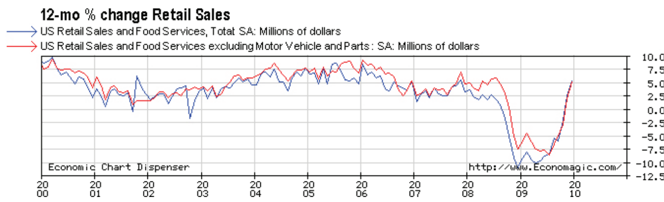


Figure 8

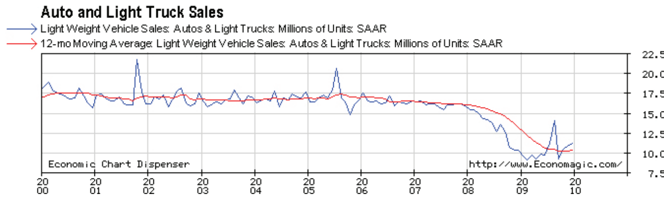


Figure 9

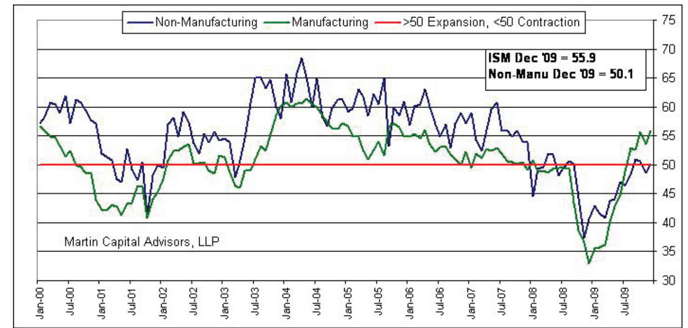


Figure 10

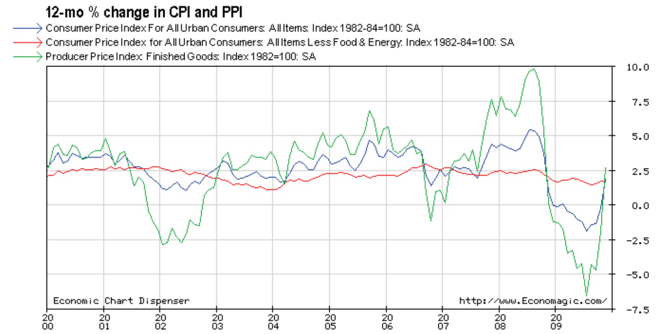
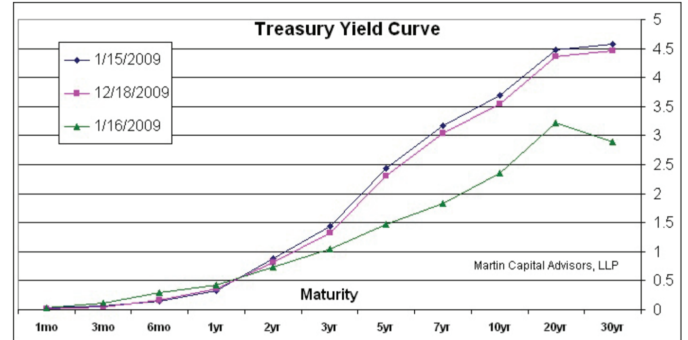


Figure 11



MARKET AND ECONOMIC STATISTICS

as of Market Close December 31, 2009 with 3-month and 12-month percentage changes

3rd Qtr. '09	Final	3 mo	12 mo
GDP-Bil Chained$	12973	0.5% apr	–2.6%
GDP Deflator	109.8	0.1% apr	0.6%
Empl Cost Index	110.7	0.3%	1.4%
NF Productivity	148.5	2.0% apr	4.3%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	10424	7.0%	18.8%
S&P 500	1115	5.0%	23.4%
NASDAQ Comp	2269	6.4%	43.9%
NASDAQ 100	1860	7.9%	53.6%
NYSE Comp	7184	3.7%	24.8%
Wilshire 5000	11497	4.9%	26.5%
Russell 2000	625	2.4%	25.2%

*excluding dividends

INTEREST RATES		3 mo	12 mo
10-yr T-Note Yld	3.85%	+0.54 bp	+1.6 bp
3-mo T-Bill Rate	0.06%	–0.8 bp	–0.5 bp
Trea Spd 10y-3mo	3.79%	+0.45 bp	+0.86 bp
Fed Funds Trgt	0.05%	–0.02 bp	–0.08 bp
Prime Rate	3.25%	0.00 bp	0.00 bp
FNMA 30yr mortg	4.53%	+0.4 bp	0.00 bp
Barclays Agg Bond	103.19	–1.73	–1.01

PRICES, INFLATION		3 mo	12 mo
CPI-U, Dec	217.5	0.8%	2.8%
CPI Core, Dec	220.7	0.3%	1.7%
PCE Core Defl, Nov	110.3	0.6%	1.5%
Gold, cash $/tr oz	1095.7	8.8%	25.0%
W Tx Int Cr Oil $/bbl	79.60	12.7%	71.1%
Copper	332.70	18.6%	130.7%
CRB Futures Ind	253.7	1.7%	–27.0%

INDUSTRY		3 mo	12 mo
ISM Manuf Ind, Dec	55.9	3.3	23.0
ISM Services, Dec	50.1	–0.8	9.5
Cap Utiliz, Nov	71.3%	1.2%	–3.1%
Bldg Permits, Nov	589K	1.5%	–6.5%

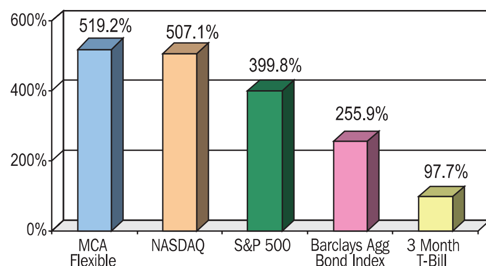
SALES		3 mo	12 mo
Total Retail-$B, Nov	353.9	0.8%	2.5%
Ttl ex Autos-$B, Nov	294.0	2.5%	2.0%
Autos-M Units, Dec	11.2	22.0%	8.7%
New Homes, Nov	355K	–17.2%	–9.0%

LABOR – Dec '09		3 mo	12 mo
Unemployment Rate	10.0%	0.2%	2.6%
Non-Farm Jobs Chg.	–85K	–208K	–4164K
Avg Init Unempl Clms	460.2K	–82K	73.8K
Avg Hourly Wages	18.82	0.8%	2.2%

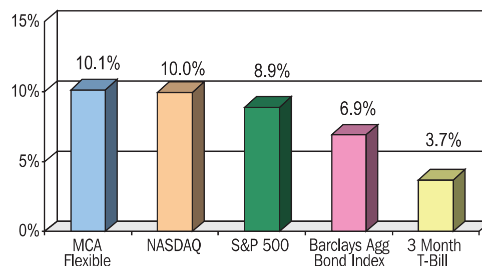
RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to December 31, 2009

Total Return



Annualized Return



A Quarterly Publication of
MARTIN CAPITAL ADVISORS, LLP

1101 Capital of Texas Highway
Bldg K., Suite 150
Austin, Texas 78746
512-477-7036 • 877-477-7036

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, 2009

#	Position	Price	#	Position	Price	#	Position	Price	#	Position	Price
1	Apple	210.73	6	Cisco	23.94	11	OmniVision Tech	14.52	16	Quest Diagnostics	60.38
2	Charles Schwab	18.82	7	Starbucks	23.06	12	Intel	20.40	17	Bank of New York	27.97
3	Intuitive Surgical	303.43	8	Texas Instruments	26.06	13	Tiffany	43.00	18	Caterpillar	56.99
4	Oracle	24.53	9	Davita	58.74	14	Sandisk	28.99	19	NASDAQ Biotech Index	81.83
5	Whole Foods	27.45	10	Black Rock	232.20	15	William Sonoma	20.78	20	Applied Materials	13.94

COMPARISON OF INVESTMENT RESULTS

Performance of Relevant Indexes

	Martin Capital Advisors[1]	NASDAQ	S&P 500	Dow Jones Industrial Avg.	Dow Jones Wilshire 5000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
1991	33.8%	56.9%	30.6%	24.5%	34.2%	18.5%	5.6%	3.1%
1992	26.5%	15.5%	7.7%	7.3%	9.0%	8.0%	3.5%	2.9%
1993	14.3%	14.8%	10.0%	17.0%	11.3%	17.3%	2.9%	2.8%
1994	-2.0%	-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	29.2%	22.7%	23.1%	28.7%	21.2%	-0.8%	5.2%	3.3%
1997	41.6%	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	58.3%	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%
2008	-55.1%	-40.5%	-37.0%	-33.8%	-37.3%	5.2%	1.8%	-0.1%
2009	72.1%	43.9%	26.5%	22.7%	28.3%	5.9%	0.2%	3.1%
Total[2]	519.1%	467.8%	371.3%	500.5%	424.7%	255.2%	97.7%	62.0%
Avg.[3]	10.1%	10%	8.9%	9.9%	9.1%	6.9%	3.7%	2.6%

[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]1991-2009 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 25 individual portfolios and 32% of all funds under management by MCA on 12/31/09. 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.