THE COMPASS

July 2010

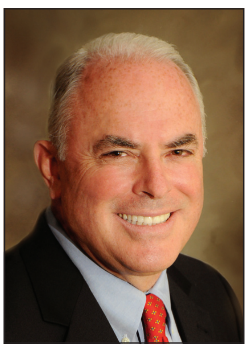
A Quarterly Newsletter of Martin Capital Advisors, LLP

## INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

### Stock Market Correction is Probably Over as Economy Transitions into Sustainable Growth Cycle

*July 23, 2010*

The stock market correction anticipated in the April newsletter unfolded over the course of the last two months of the second quarter as the economy began to show signs of down shifting from rapid growth to sustainable expansion. Historically, this is the point in all economic recoveries when financial markets react to fears of a double-dip recession, even though double-dips are quite rare – the last one occurring in 1982 when the Fed raised rates immediately after the 1981 recession to fight high inflation. This time, the Fed has remained accommodative, so the odds of a double-dip are extremely low, but, as in previous recoveries, this has not stopped the stock market from reacting to the fear of another recession. As we near the end of July, the S&P 500 has rebounded from its July 1 intra-day low. My guess is that we probably already have seen the worst of the current correction, and that stocks will be significantly higher later this year.

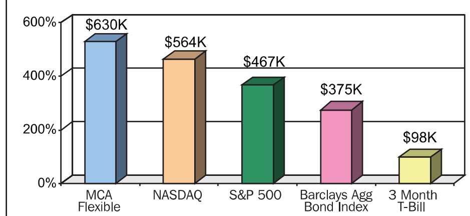


Bond prices climbed and yields declined in the second quarter in reaction to the increased prospect of low inflation due to softening economic data. This is also typical in the transition stage from initial economic recovery to normal growth – bonds experience a counter-trend rally while stocks languish in the face of economic uncertainty caused by double-dip recession fears, which, as mentioned before, very rarely materialize. If, in fact, historical precedence prevails and the economic expansion continues at a sustainable pace, then bond prices, especially Treasuries, will probably fall as the bull market in stocks resumes.

Unfortunately, unemployment will most likely remain high for the next few years. This is due in part to the severity of the last recession and in part to companies being slow to hire until there are no other options to meet rising demand. While the negative effects of high unemployment are obvious, it should be noted that the effect of doing more with fewer workers increases productivity and explains why corporate earnings tend to be better than expected in the first few years of economic recoveries. As they have for the past year and so far this quarter, corporate earnings are continuing to come in much better than expected. This confirms that the virtuous cycle of self-reinforcing growth is still underway and that the record levels of corporate cash will eventually be used to hire more workers, which bodes well for the stock market and the economic recovery.

**Growth of $100K**

1/1/91–6/30/10




See details and important Disclosure Notice on last page.

## COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to June 30, 2010

| | 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 |
|---|---|---|---|---|---|---|---|---|
| Total[2] | 529.5% | 464.2% | 366.5% | 481.9% | 397.7% | 274.9% | 97.8% | 62.8% |
| Avg.[3] | 9.9% | 9.3% | 8.3% | 9.5% | 8.6% | 7.0% | 3.6% | 2.6% |

[1]Total annual performance, net of commissions, fees, and expenses of all Martin Capital Advisors' *Flexible Portfolios.*

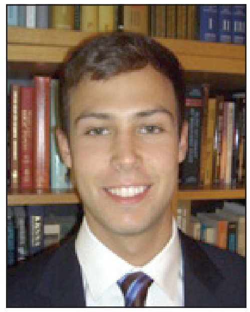
[2]Total compounded return, including reinvestment of dividends and interest. [3]1991-2010 annualized return.

—— See Important Disclosure Notice on back page. ——

# QUARTERLY ECONOMIC REVIEW by Colton Krueger, Economic Analyst

July 12, 2010

During the first quarter 2010, the U.S economy grew at an annualized rate of 2.7%. This was the third consecutive quarter of growth; however, the pace was much slower in comparison to the fourth quarter 2009 in which GDP increased at an annualized rate of 5.6%. While growth was slower than expected, the U.S. economy is projected to continue growing steadily for the rest of 2010, even in the most bearish of estimates. **(Figure 1)**



Unemployment continues to be a drag on the economy and investor sentiment. In June the total nonfarm payrolls dropped 125,000. Though this decline was somewhat worse than expected, it was negatively skewed by the loss of 225,000 temporary 2010 Census jobs. The unemployment rate dropped to 9.5% and private-sector payroll employment edged up 83,000 in June compared to 33,000 in May. The concern, however, is not that the economy will continue to shed jobs, but that the private sector is still reluctant to hire. **(Figures 2, 3, 4)**

Manufacturing indexes in June showed signs that the U.S. economy is slowing down from its initial V-like recovery. The ISM manufacturing index was reported at 56.2%, which was a decline of 3.5% compared to May. While this number reflects a slowdown, it still shows that manufacturing is continuing to grow at a healthy pace. In the ISM press release, the report noted that this slowdown is not unusual, especially given the fact that the U.S. has experienced 11 consecutive months of manufacturing expansion. The ISM Non-Manufacturing Index also confirmed a slowdown. The reading in June fell 2.6% compared to May, which was the slowest pace of growth since February. **(Figure 5)**

Consumer confidence fell significantly in June. The Conference Board reported that consumer confidence dropped to 52.9 in June compared to 62.7 in May. The drop in confidence marked the end to a three-month consecutive increase in the Conference Board's reading. The decrease in confidence appears to be affecting consumer's pocketbooks. After seven months of increasing sales, retail sales decreased 1.4% in May. While this marks a pullback, it is not necessarily a reason to be alarmed as retail sales are up 6.9% for the year and are 8.1% higher in comparison to the three-month average a year ago. **(Figures 6, 7)**

The first-time homebuyer's federal tax credit, which gave new buyers an $8,000 credit, expired at the end of April. The credit helped stabilize prices and eliminated some inventory, but its expiration contributed to the 33% plunge in new homes sales and the 10% plunge in housing starts for May. The reading for housing starts was the lowest since December, but is 7.8% higher compared to a year ago. Housing permits, which gauge future construction, fell 5.9% in May, but are 4.4% higher compared to a year ago. While the expiration of the tax credit made purchasing a home not as attractive, unprecedented incentives still exist for homebuyers. Recently, Freddie Mac reported that the average rate of interest on a fixed-rate 30-year mortgage has dropped to 4.57%, which is the lowest rate since 1971. **(Figure 8)**

Low inflation and a strong demand for bonds have continued to keep bond yields below their historical averages. At the end of the second quarter, the yield on the 10-year Treasury note dropped 0.87%, to yield less than 3%. This shows that investors continue to expect low inflation well into the future, as the expected inflation derived from the prices of index-linked bonds is about 2 percent. **(Figure 9)**

Deflationary pressures still persist in the economy due to slack in capacity utilization and high unemployment. In May the consumer price index (CPI) dropped -0.2%, while core CPI was up 0.1%. On a year-over-year basis CPI is up 2.0% and core CPI is up 1%. **(Figure 10)**

**Figure 1**

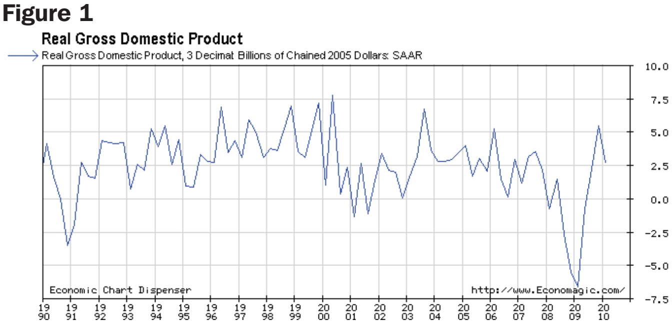



**Figure 3**

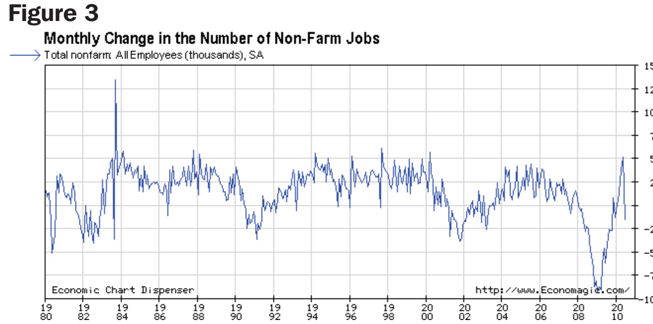



**Figure 2**


**Figure 4**

Figure 5

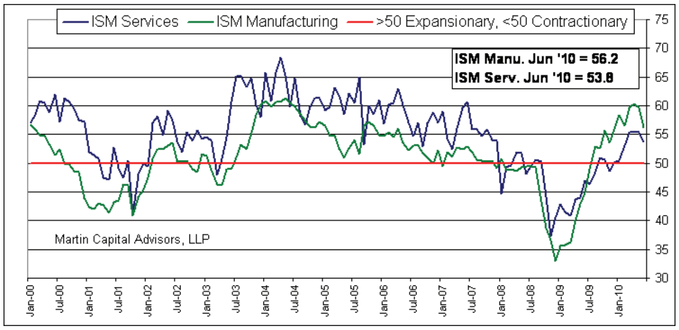



Figure 8

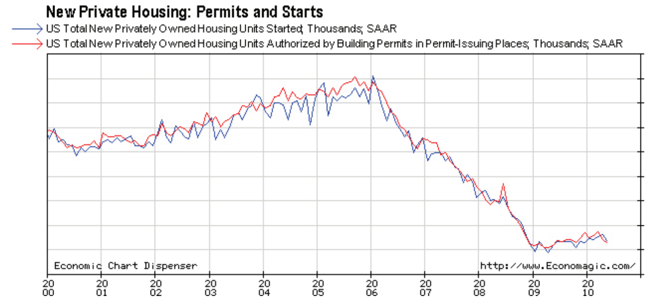



Figure 6

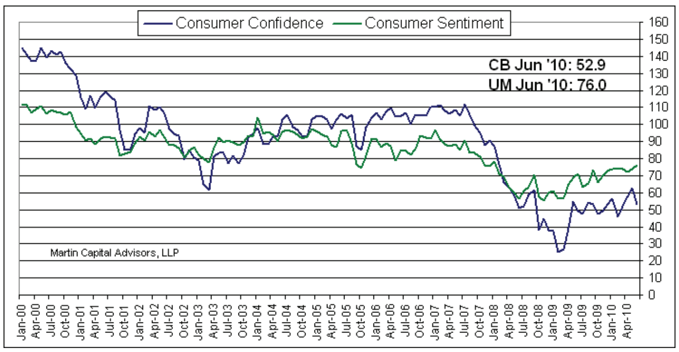



Figure 9

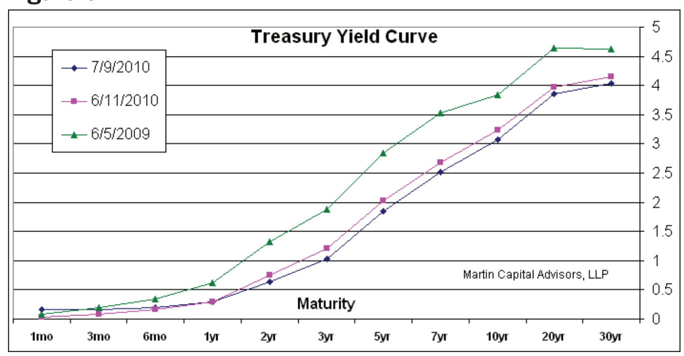



Figure 7

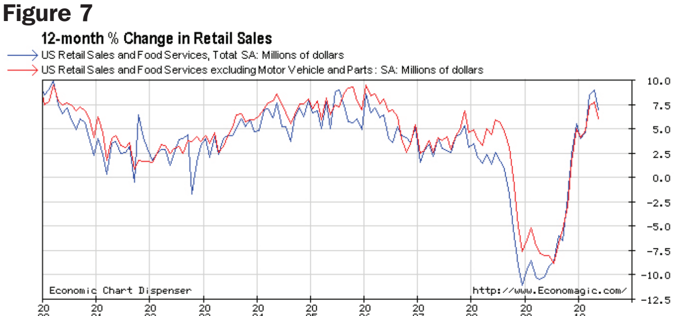
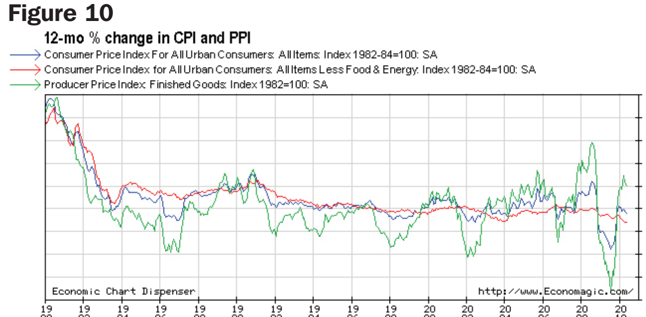



Figure 10




# MARKET AND ECONOMIC STATISTICS

## as of Market Close June 30, 2010
## with 3-month and 12-month percentage changes

| 1st Qtr. '10 | Final | 3 mo | 12 mo |
|---|---|---|---|
| GDP-Bil Chained$ | 13238 | 2.7% apr | 2.4% |
| GDP Deflator | 110.2 | 1.2% apr | 0.5% |
| Empl Cost Index | 111.4 | 0.4% | 1.5% |
| NF Productivity | 153.1 | 2.8% apr | 6.1% |

| STOCK INDICES* | | 3 mo | 12 mo |
|---|---|---|---|
| Dow Industrials | 9774 | –10.4% | 15.7% |
| S&P 500 | 1030 | –12.0% | 12.0% |
| NASDAQ Comp | 2109 | –12.2% | 14.9% |
| NASDAQ 100 | 1739 | –11.4% | 17.7% |
| NYSE Comp | 6469 | –13.1% | 9.6% |
| Wilshire 5000 | 10750 | –11.9% | 14.1% |
| Russell 2000 | 609 | –10.6% | 19.9% |

*excluding dividends

| INTEREST RATES | | 3 mo | 12 mo |
|---|---|---|---|
| 10-yr T-Note Yld | 2.97% | –0.87% | –0.62% |
| 3-mo T-Bill Rate | 0.18% | +0.02% | –0.01% |
| Trea Spd 10y-3mo | 2.79% | –0.84% | –0.55% |
| Fed Funds Trgt | 0.09% | +0.00% | –0.13% |
| Prime Rate | 3.25% | 0.00% | 0.00% |
| FNMA 30yr mortg | 4.25% | –0.25% | –0.63% |
| Barclays Agg Bond | 2.83% | –0.64% | –1.29% |

| PRICES, INFLATION | | 3 mo | 12 mo |
|---|---|---|---|
| CPI-U, May | 217.2 | –0.2% | 2.0% |
| CPI Core, May | 221.0 | 0.2% | 1.0% |
| PCE Core Defl, May | 110.1 | 0.4% | 1.3% |
| Gold, cash $/tr oz | 1241.8 | 11.6% | 33.9% |
| W Tx Int Cr Oil $/bbl | 75.37 | –9.6% | 7.8% |
| Copper | 290.85 | –17.7% | 27.4% |
| CRB Futures Ind | 258.5 | –5.4% | 3.6% |

| INDUSTRY | | 3 mo | 12 mo |
|---|---|---|---|
| ISM Manuf Ind, May | 59.7 | 3.2 | 16.5 |
| ISM Services, May | 55.4 | 2.0 | 11.4 |
| Cap Utiliz, May | 74.1% | 1.7% | 5.8% |
| Bldg Permits, May | 574K | –11.7% | 4.4% |

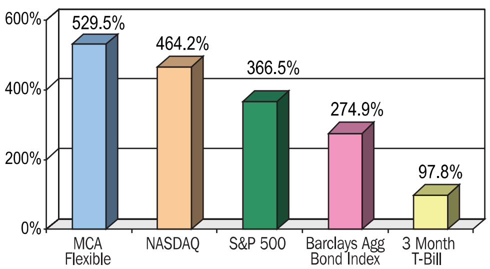
| SALES | | 3 mo | 12 mo |
|---|---|---|---|
| Total Retail-$B, May | 362.5 | 1.5% | 6.9% |
| Ttl ex Autos-$B, May | 300.6 | 0.7% | 6.0% |
| Autos-M Units, Jun | 11.1 | –5.9% | 14.3% |
| New Homes, May | 300K | –13.5% | –18.3% |

| LABOR – May '10 | | 3 mo | 12 mo |
|---|---|---|---|
| Unemployment Rate | 9.7% | 0.0% | +0.3% |
| Non-Farm Jobs Chg. | +433K | +954K | –560K |
| Avg Init Unempl Clms | 463K | +8K | –167K |
| Avg Hourly Wages | 19.00 | 0.4% | 2.4% |

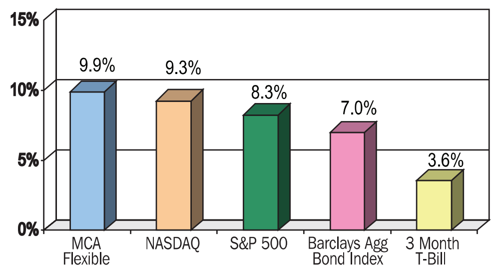
## RELATIVE LONG-TERM PERFORMANCE

**January 1, 1991 to June 30, 2010**

### Total Return




### Annualized Return

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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.

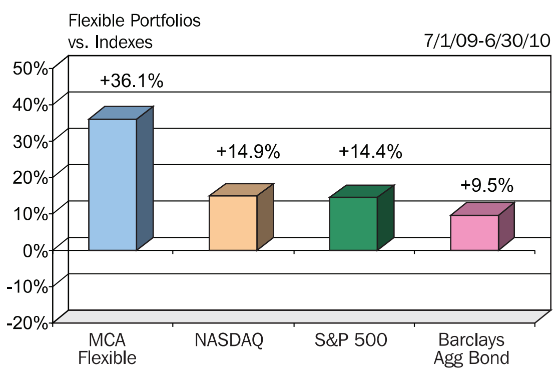
## FLEXIBLE PORTFOLIO TOP 20 POSITIONS

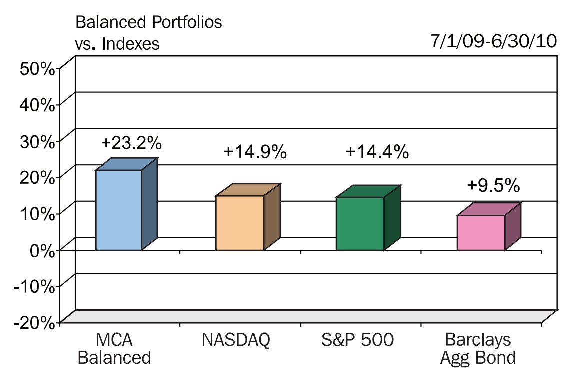
**as of June 30, 2010**

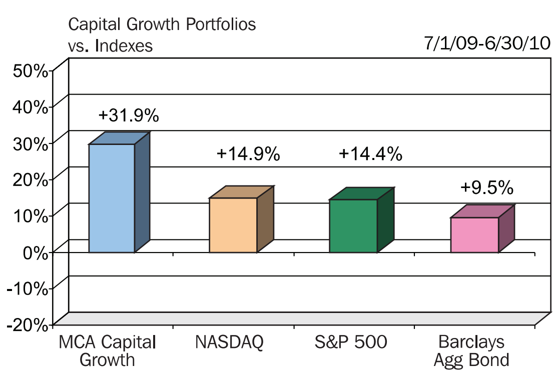
| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Apple | 251.53 | 6 | Charles Schwab | 14.18 | 11 | Davita | 62.44 | 16 | Caterpillar | 60.07 |
| 2 | Whole Foods Market | 36.02 | 7 | Omnivision Tech | 21.44 | 12 | Williams Sonoma | 24.82 | 17 | Peet's Coffee & Tea | 39.27 |
| 3 | Intuitive Surgical | 315.62 | 8 | Cisco | 21.31 | 13 | Intel | 19.45 | 18 | Quest Diagnostics | 49.77 |
| 4 | Oracle | 21.46 | 9 | SanDisk | 42.07 | 14 | iShares Russell 3000 | 61.08 | 19 | NASDAQ Biotech Index | 77.52 |
| 5 | Starbucks | 24.30 | 10 | Texas Instruments | 23.28 | 15 | Tiffany | 37.91 | 20 | Blackrock, Inc. | 143.40 |

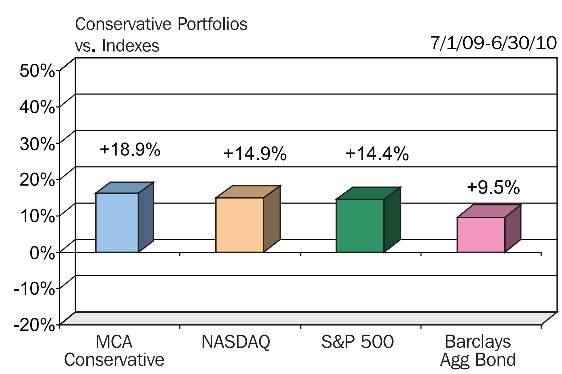
## INVESTMENT RESULTS

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




**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 23 individual portfolios and 32% of all funds under management by MCA on 6/30/10. 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.