# THE COMPASS

October 2010

A Quarterly Newsletter of Martin Capital Advisors, LLP

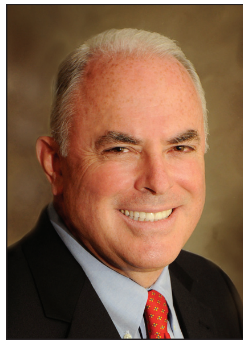
## INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

### Stocks Rally in Third Quarter as Corporate Earnings Continue to be Stronger than Anticipated

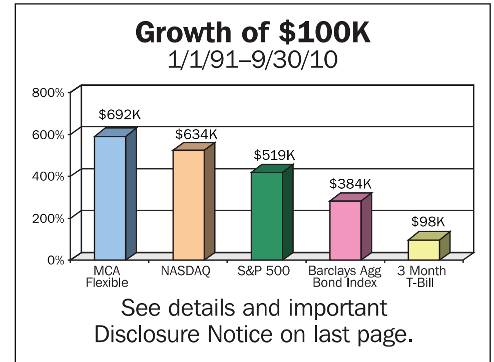
*October 28, 2010*

The third quarter saw stocks rebound significantly off the early July correction lows as corporate earnings continued to surprise to the upside. The rebound has carried forward into the fourth quarter, so far, with stocks nearly recovering all of the correction losses suffered since late April and achieving double digit gains year-to-date. Bond returns were fairly good in the third quarter, but have been mediocre thus far into the fourth quarter. Commodity prices were strong for the most part during the third quarter and have continued to advance into the fourth quarter, perhaps a harbinger of the return of inflation as the economic recovery advances.

In light of the strong stock market rally over the last two months, the risk of a correction has increased; however, it would probably be a mistake to try to take advantage of any potential short-term weakness, since the mid- to long-term trends are pointing to higher prices as the Fed remains accommodative and the global economic recovery marches on. Although I would not be surprised to see a five percent pullback from current levels, the odds are good that stock market prices will be higher over the next three to six months, and the odds are even better that prices will be higher over the next several years. Bond prices, especially Treasuries, however, appear to be in a bubble that will eventually pop as the economy expands and inflation subsequently becomes an issue again.



Despite further economic expansion and increasing corporate earnings, unemployment will take quite a while to drop back to an acceptable rate. In all previous economic recoveries unemployment has never been a leading or coincident indicator. It has always been a lagging indicator, i.e., improving economic and financial conditions lead to improving employment, not the other way around, so those who are waiting for employment conditions to improve dramatically before investing in equities are ignoring a long history of bull markets that have begun well before employment has shown significant signs of improvement. Even in the face of exceptionally high unemployment, the current bull market mirrors the gains seen in the early stages of all economic recoveries. Based on historical precedents, stock prices over the next few years will likely climb well beyond the expectations of most investors.




See details and important Disclosure Notice on last page.

## COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to September 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] | 592.9% | 533.6% | 419.2% | 552.0% | 458.0% | 284.2% | 97.9% | 54.0% |
| Avg.[3] | 10.3% | 9.8% | 8.7% | 10.0% | 9.1% | 7.1% | 3.5% | 2.5% |

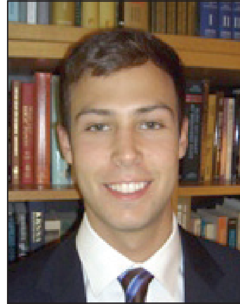
[1]Total annual performance, net of commissions, fees, and expenses of all Martin Capital Advisors' *Flexible Portfolios.*

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

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

The U.S. economy grew at a 1.7 percent annual rate in the second quarter, which marked a considerable slowdown in comparison with the previous two quarters in which GDP expanded at an annual rate of 2.7 and 5.6 percent respectively. **(Figure 1)**

Since May, the "V" shaped rebound in employment has lost momentum, partly due to the layoffs of government workers who had been hired earlier in the year for the 2010 Census. Also, state and local governments have begun laying off employees in order to balance weakened budgets. In total, 159,000 government employees were laid off in September. The private sector, however, continues to add jobs, creating 64,000 jobs in September. The loss of government jobs and the addition of private sector jobs resulted in a net loss in the last month of 95,000 jobs. **(Figure 2, 3, 4)**



Manufacturing continues to be the mainstay of the economic recovery. The Institute for Supply Management reported that manufacturing for the month of September was 54.4 and nonmanufacturing was recorded at 53.8. While these numbers are still well above the mark of 50 that signifies expansion, they are below the very strong readings recorded earlier this year. **(Figure 5)**

Confidence in the economy remains weak. In September, consumer confidence declined to 48.5 from 53 in August. Confidence continues to be weak as high unemployment persists. Despite falling confidence, one bright spot in the economy is consumer spending. In the past quarter, consumer spending rose at a 2.2 percent pace, which was the fastest three-month increase recorded since the beginning of 2007. In conjunction with the rise in consumer spending, retail sales increased 1.4 percent over the quarter. The boost in consumer spending comes at a time when savings rates in the U.S. are at their highest levels since the 1990s. Savings rates have risen from about 2 percent in the mid-2000s to nearly 6 percent today. **(Figure 6, 7)**

The housing sector, which was the first sector of the economy to show weakness, continues be a drain on the economy. In July, existing home sales were the weakest in 15 years, and new home sales were at their lowest levels dating back to the 1960s when records were first recorded. The housing sector has yet to show sustained growth without direct incentives from the government. The spikes in activity seen earlier this year were caused by the first-time homebuyer tax credit; however, when the credit expired in April the housing sector plummeted. **(Figure 8)**

Low inflation, a strong demand for bonds, and the Fed hinting at a new round of quantitative easing has kept bond yields far below their historical averages. The yield on the 10-year Treasury note has remained below 3 percent since the beginning of August, falling as low as 2.41 percent recently. Bond yields are expected to remain low as the market projects that the Fed will keep interest rates close to zero at least into early next year. **(Figure 9)**

Deflationary pressures still persist in the economy. In the past 12 months, prices have only risen 1.2 percent. This yearly increase is well below the 2 percent rate targeted by the Fed, which is why Ben Bernanke recently said that inflation remains "somewhat below" the levels that are consistent with the Federal Reserve's congressional mandate. The Feds comments on new measures it may take to fight deflation have caused the financial markets to anticipate that a new round of quantitative easing will be announced at the next Fed meeting in November. **(Figure 10)**

**Figure 1**

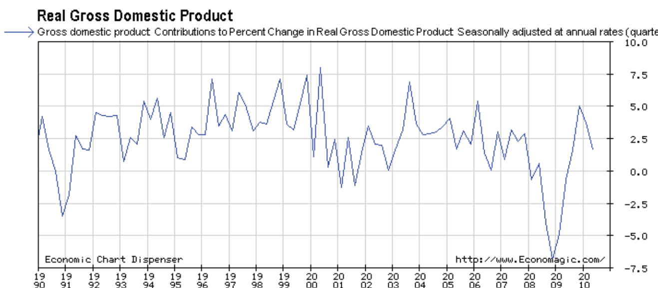



**Figure 3**

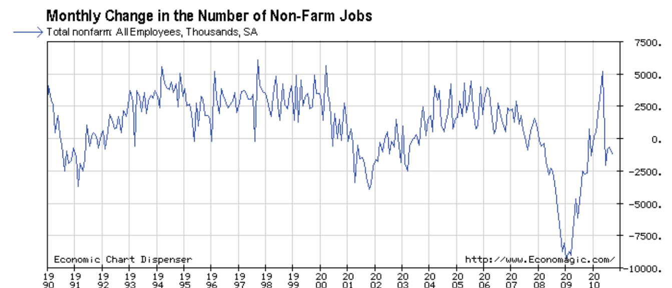



**Figure 2**

**Figure 4**

**Figure 5**

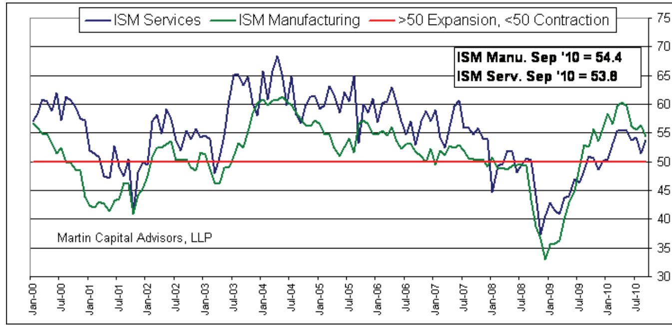



**Figure 8**

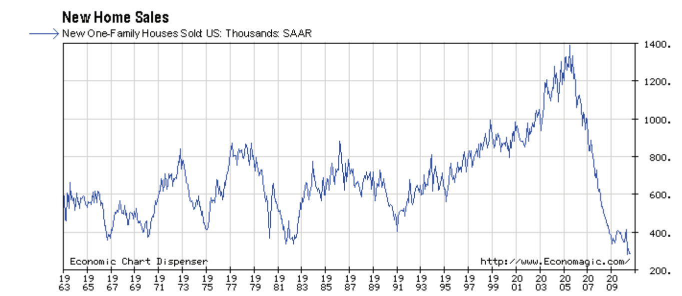



**Figure 6**

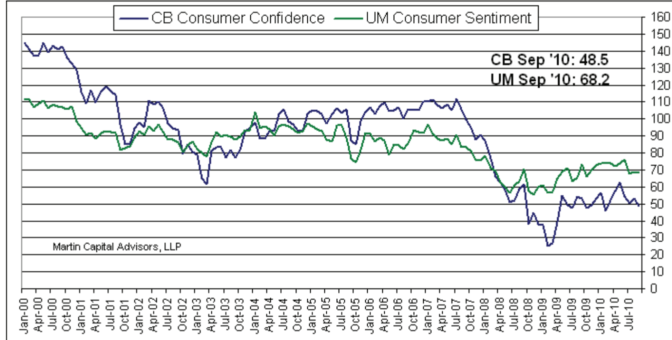



**Figure 9**

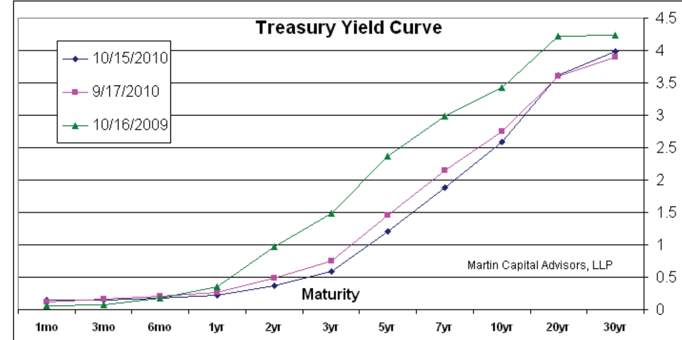



**Figure 7**

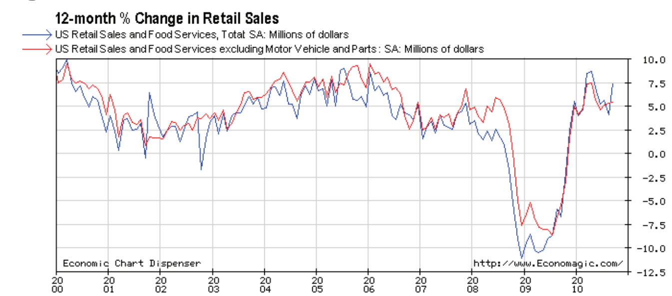
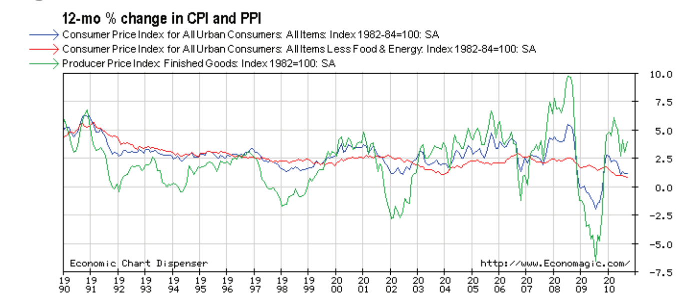



**Figure 10**




# MARKET AND ECONOMIC STATISTICS

## Third Quarter 2010
## with 3-month and 12-month percentage changes

| 2nd Qtr. '10 | Final | 3 mo | 12 mo |
|---|---|---|---|
| GDP-Bil Chained$ | 13195 | 1.7% apr | 3.0% |
| GDP Deflator | 110.4 | 1.6% apr | 0.7% |
| Empl Cost Index | 111.9 | 0.4% | 1.6% |
| NF Productivity | 110.4 | –1.8% apr | 3.7% |

| STOCK INDICES* | | 3 mo | 12 mo |
|---|---|---|---|
| Dow Industrials | 10778 | 10.4% | 10.7% |
| S&P 500 | 1141 | 10.8% | 7.5% |
| NASDAQ Comp | 2368 | 12.3% | 11.1% |
| NASDAQ 100 | 1998 | 14.9% | 16.0% |
| NYSE Comp | 7299 | 12.8% | 13.6% |
| Wilshire 5000 | 11947 | 11.1% | 9.1% |
| Russell 2000 | 676 | 11.0% | 10.8% |

*excluding dividends

| INTEREST RATES | | 3 mo | 12 mo |
|---|---|---|---|
| 10-yr T-Note Yld | 2.53% | –0.44% | –0.78% |
| 3-mo T-Bill Rate | 0.16% | –0.02% | 0.02% |
| Trea Spd 10y-3mo | 2.37% | –0.42% | –0.80% |
| Fed Funds Trgt | 0.15% | 0.06% | 0.08% |
| Prime Rate | 3.25% | 0.00% | 0.00% |
| FNMA 30yr mortg | 4.32% | 0.07% | –0.17% |
| Barclays Agg Bond | 2.56% | –0.27% | –0.96% |

| PRICES, INFLATION | | 3 mo | 12 mo |
|---|---|---|---|
| CPI-U, Sep | 218.3 | 0.6% | 1.1% |
| CPI Core, Aug | 221.7 | 0.2% | 0.8% |
| PCE Core Defl, Aug | 111.2 | 0.3% | 1.4% |
| Gold, cash $/tr oz | 1308.1 | 4.8% | 29.0% |
| W Tx Int Cr Oil $/bbl | 79.8 | 5.8% | 14.2% |
| Copper | 365.4 | 25.6% | 26.0% |
| CRB Futures Ind | 286.8 | 10.8% | 12.9% |

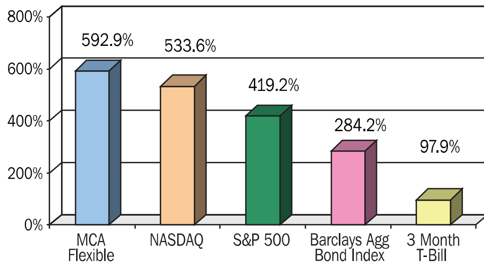
| INDUSTRY | | 3 mo | 12 mo |
|---|---|---|---|
| ISM Manuf Ind, Sep | 54.4 | –1.8 | 2.0 |
| ISM Services, Sep | 53.2 | –0.6 | 3.1 |
| Cap Utiliz, Sep | 74.7% | 0.5% | 4.2% |
| Bldg Permits, Sep | 539K | –7.5% | –10.9% |

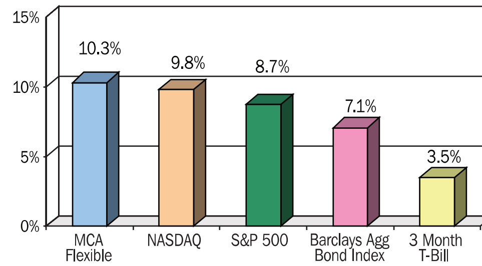
| SALES | | 3 mo | 12 mo |
|---|---|---|---|
| Total Retail-$B, Sep | 367.6 | 1.8% | 7.3% |
| Ttl ex Autos-$B, Sep | 304.3 | 1.6% | 5.4% |
| Autos-M Units, Sep | 11.7 | 5.2% | 25.3% |
| New Homes, Aug | 288K | 2.1% | –28.8% |

| LABOR – Sep '10 | | 3 mo | 12 mo |
|---|---|---|---|
| Unemployment Rate | 9.6% | 0.1% | –0.2% |
| Non-Farm Jobs Chg. | –95K | –218K | 344K |
| Avg Init Unempl Clms | 458K | –5K | –74K |
| Avg Hourly Wages | 19.10 | 0.5% | 2.3% |

## RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to September 30, 2010



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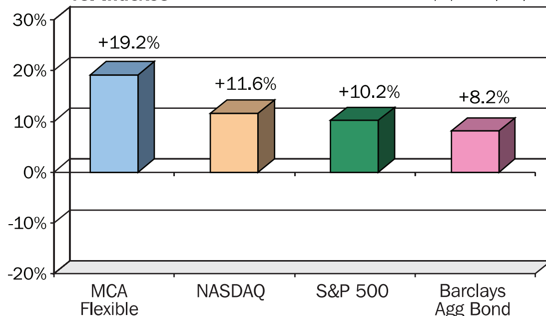
## FLEXIBLE PORTFOLIO TOP 20 POSITIONS

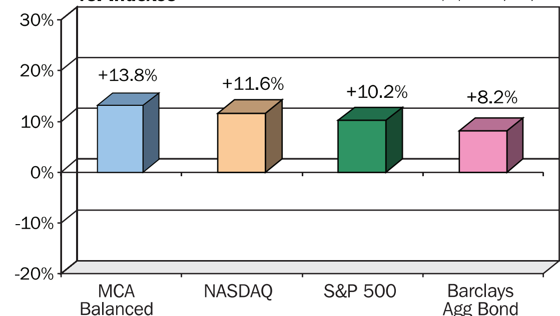
as of September 30, 2010

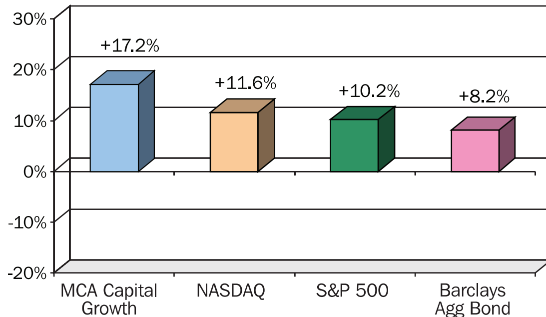
| # | Position | Price | # | Position | Price | # | Position | Price | # | Position | Price |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Apple | 283.75 | 6 | Omnivision Tech | 23.04 | 11 | Texas Instruments | 27.14 | 16 | Intel | 19.20 |
| 2 | Whole Foods Market | 37.11 | 7 | Ultra QQQ | 66.29 | 12 | Davita | 69.03 | 17 | iShares Russell 3000 | 67.45 |
| 3 | Oracle | 26.85 | 8 | Charles Schwab | 13.90 | 13 | SanDisk | 36.65 | 18 | Blackrock | 170.25 |
| 4 | Intuitive Surgical | 283.74 | 9 | Cisco Systems | 21.90 | 14 | Caterpillar | 78.68 | 19 | NASDAQ Biotech Index | 86.24 |
| 5 | Starbucks | 25.55 | 10 | Williams Sonoma | 31.70 | 15 | Tiffany | 46.99 | 20 | Coach | 42.96 |

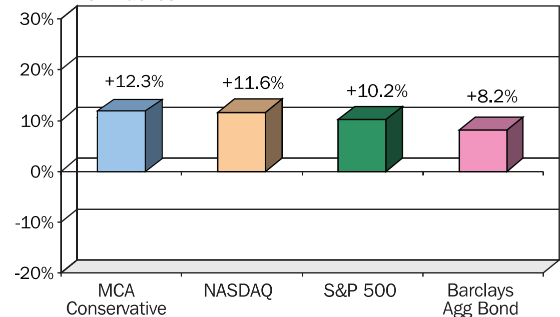
## INVESTMENT RESULTS

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 9/30/10. 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.