THE COMPASS

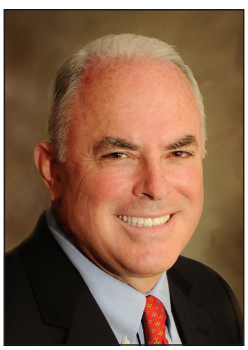
January 2011 — **A Quarterly Newsletter of Martin Capital Advisors, LLP**

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Economic Expansion Continues as Fed Remains Highly Accommodative

January 24, 2011

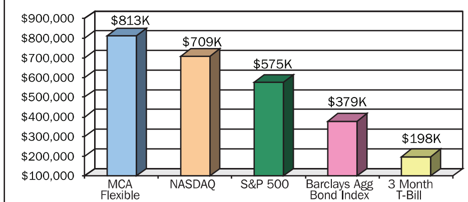
Stocks recorded another strong quarter and year as the economy and corporate profits continued to improve under a highly accommodative Federal Reserve monetary policy. Commodity prices also fared well with improving demand for a variety of resources. Fixed income investments, however, performed poorly for the quarter, resulting in a mixed performance for the year, due to decreasing concerns about deflation and rising prospects that inflation may become an issue again in the not too distant future.



As we enter 2011, the huge stock market advance since late August has increased the odds of a market correction in the near-term. This correction is likely to be somewhat greater than the mild correction that occurred in November, but I don't expect it to be any worse than other drawdowns experienced since the bull market began almost two years ago. That said, it is important to repeat the refrain of recent editions of *The Compass*: investors should stay with stocks through periodic corrections in order to fully participate in the resumption of the bull market after the corrections have run their course.

Although large budget deficits and high unemployment remain a threat to economic growth, the U.S. is on track for meeting these challenges through monetary and fiscal stimuli. On the monetary side, the Fed is clearly focused on the employment portion of its dual mandate for low inflation and full employment. This means that economic growth and the concomitant inflationary effects associated with it will be allowed to rise more than normally would be tolerated by the Fed in order to bring down high unemployment. On the fiscal side, high unemployment thus far has persuaded Congress and the president to be careful about taking fiscal stimulus out of the economy too quickly. Over time, the budget deficit will have to be reduced with both spending cuts and higher taxes, but as long as this is done gradually the economy should stay on course to grow at a rate sufficient to bring down unemployment and sustain higher corporate earnings. Since monetary and fiscal policy makers will probably continue to discount the risk of higher inflation and be supportive of faster economic growth until unemployment drops to an acceptable rate, stocks should be over-weighted and bonds under-weighted in investment portfolios for at least the next few years.

Growth of $100K
1/1/91–12/31/10



See details and important Disclosure Notice on last page.

COMPARISON OF INVESTMENT RESULTS

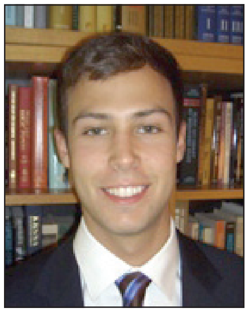
January 1, 1991 to December 31, 2010

	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]	713.5%	609.7%	475.1%	604.5%	523.0%	279.3%	98.0%	64.0%
Avg.[3]	11.0%	10.3%	9.2%	10.3%	9.6%	6.9%	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 an annualized rate of 2.6 percent in the third quarter. This marked the fifth consecutive quarter of expansion. While the third quarter's growth was not particularly strong, it was much better than the second quarter's annual growth rate of 1.7 percent. Economists' are optimistic about growth in 2011: according to a recent Wall Street Journal forecasting survey, GDP is expected to rise 3 percent and the odds of a double dip recession have been reduced to 15 percent. **(Figure 1)**



In December, the unemployment rate dropped from 9.8 percent to 9.4 percent, which is the lowest level in 19 months, and was the largest one-month drop in unemployment since the recession began. In general, most economists expect the unemployment rate to stay around 9 percent in 2011. **(Figure 2, 3, 4)**

Manufacturing, which led us out of the recession, continues to be strong. The ISM non-manufacturing index was up 2.1 percent in December to 57.1, marking the twelfth-straight month of service sector expansion. The ISM manufacturing index increased to 57.0, the fastest pace since May. **(Figure 5)**

In November, retail sales rose 0.8 percent to $378.7 billion. The increase in consumer spending has recovered strongly: year-over-year retail sales are up 7.7 percent; however, the increase in sales has not yet translated to a significant increase in hiring. During the recession, the retail sector lost 1.2 million jobs. In the past 12 months the industry has only added 80,000 jobs. If the economy continues to see sales increase, eventually the increase in demand will lead to job creation. **(Figure 6)**

Over the quarter confidence in the economy has improved, which is one reason why we have seen such a strong rebound in sales. Despite the strong sales numbers, consumer confidence in December declined to 52.5 from 54.3. While confidence waned in December, it had risen in the previous two months and is significantly higher than it was in September. The increase in confidence has revived the auto industry – auto and light truck sales have increased 12.6 percent year-over-year. As confidence continues to improve, consumers will begin making big purchases, which is why car manufacturers are optimistic about sales in 2011. **(Figure 7)**

After hitting its highest rate in decades during the recession, savings rates have declined for the third straight month and Americans have increased their spending in each of the last five months. One of the reasons that spending has increased is because income has risen steadily. In November, income increased 0.3 percent and spending rose 0.4 percent.

The housing sector has shown very few signs of recovery, but there has been some good news lately. In November, existing home sales were the best since the homebuyer tax credit expired last summer, increasing 5.6 percent to an annualized rate of 4.68 million sales. New home sales rose 5.5 percent, but part of the reason for the big increase was because October's numbers were so low. Foreclosures have started to slow, but still threaten the sector. In 2010, home prices were down 4.1 percent for the year and prices declined in 70 percent of national markets. Overall, new and existing home sales remain near historic lows, with foreclosures continuing to contribute to high inventories, which weigh on the prospects for a strong rebound in housing anytime soon. **(Figure 8)**

There continues to be little inflation in the economy. The consumer price index (CPI) increased only 0.1 percent in November, and only 1.1 percent for the year. However, there are some signs that inflation maybe on the rise. The producer price index (PPI) rose 2.3 percent in the fourth quarter, and the 12-month change was up 4.1 percent. The increase in PPI has been driven by increasing costs of food and energy. Food prices were up 1.0 percent and energy prices were up 2.1 percent for the year, but core PPI rose only 0.3 percent. The increase in prices that producers face has not yet translated to higher prices for consumers. **(Figure 9)**

Interest rates have risen over the quarter due to financial markets expecting a stronger economic recovery. The spreads between short and long term Treasuries have widened to near record highs, causing a steepening in the yield curve. A wider spread suggests that investors are demanding higher yields in the long-term to compensate for the risk of inflation due to economic growth. Let's hope this optimism continues in 2011. **(Figure 10)**

Figure 1

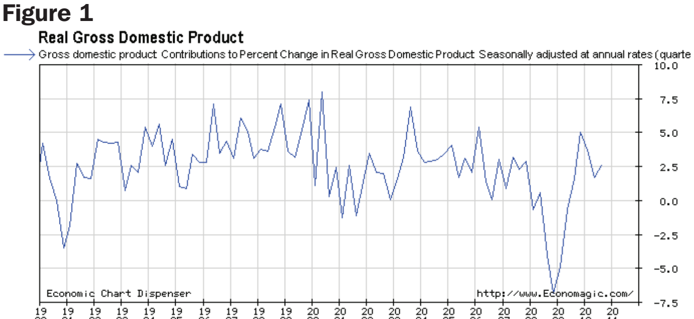


Figure 3

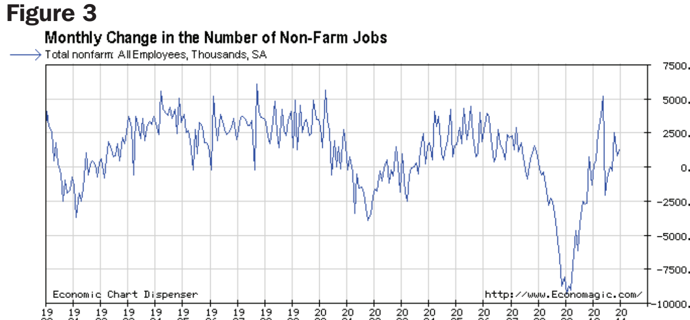


Figure 2

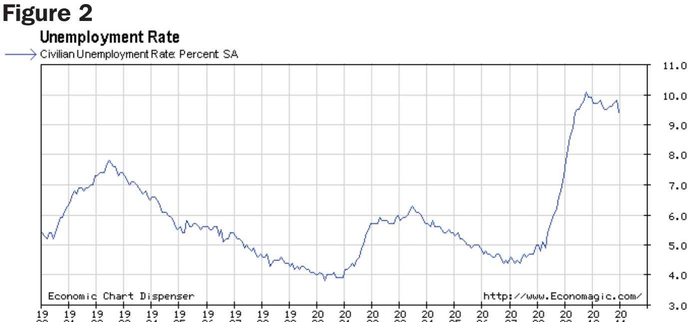


Figure 4

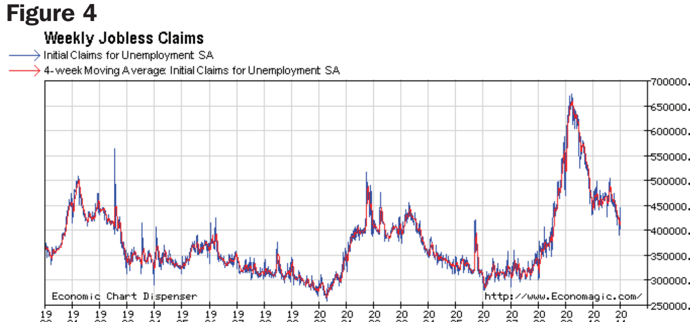


Figure 5

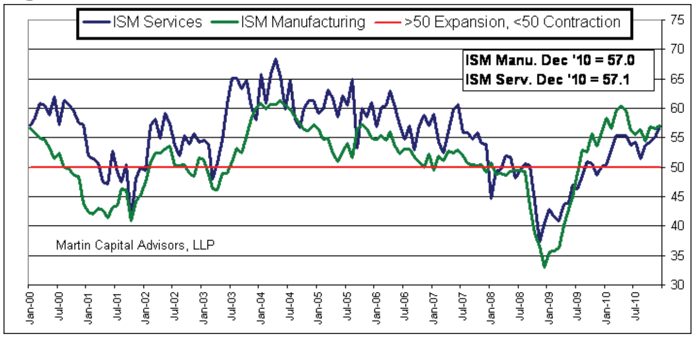


Figure 8

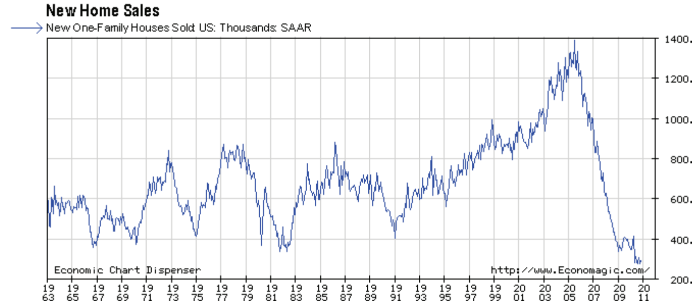
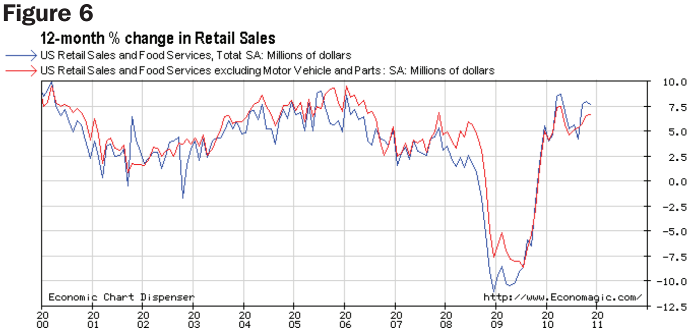


Figure 6



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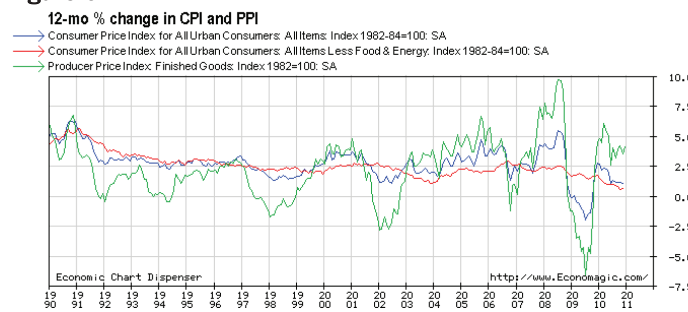


Figure 7

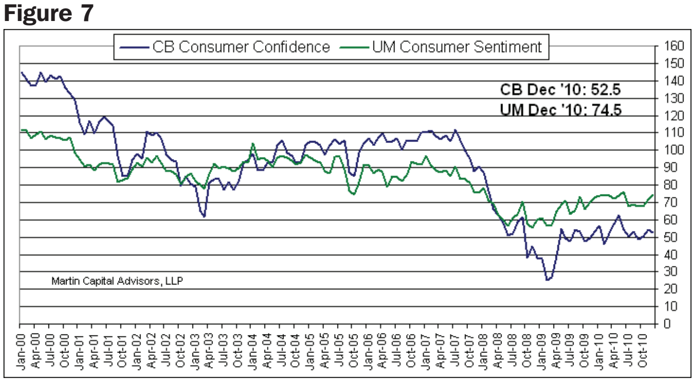
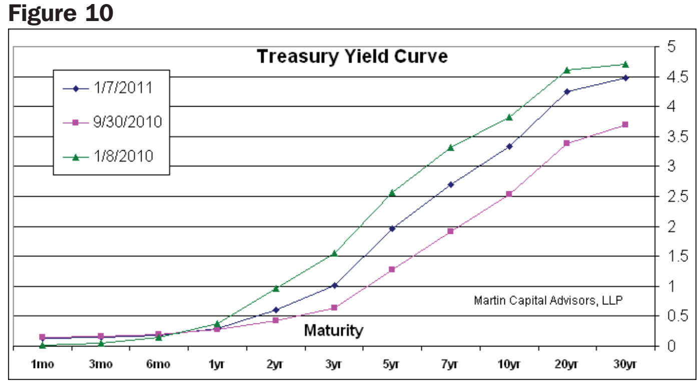


Figure 10



MARKET AND ECONOMIC STATISTICS

Fourth Quarter 2010
with 3-month and 12-month percentage changes

3rd Qtr. '10	Final	3 mo	12 mo
GDP-Bil Chained$	13278	2.6% apr	3.2%
GDP Deflator	111.0	2.0% apr	1.2%
Empl Cost Index	112.4	0.4%	1.7%
NF Productivity	111.0	2.3% apr	2.5%

STOCK INDICES*		3 mo	12 mo
Dow Industrials	11671	8.2%	11.9%
S&P 500	1257	10.1%	12.7%
NASDAQ Comp	2652	12.0%	16.9%
NASDAQ 100	2217	10.9%	19.1%
NYSE Comp	7964	9.1%	10.9%
Wilshire 5000	13360	11.8%	16.2%
Russell 2000	783	16.9%	25.3%

*excluding dividends

INTEREST RATES		3 mo	12 mo
10-yr T-Note Yld	3.30%	0.77 bp	–0.55 bp
3-mo T-Bill Rate	0.12%	–0.04 bp	0.06 bp
Trea Spd 10y-3mo	3.18%	0.81 bp	–0.61 bp
Fed Funds Trgt	0.15%	0.00 bp	0.10 bp
Prime Rate	3.25%	0.00 bp	0.00 bp
FNMA 30yr mortg	4.75%	0.43 bp	0.22 bp
Barclays Agg Bond	3.00%	0.44 bp	0.19 bp

PRICES, INFLATION		3 mo	12 mo
CPI-U, Nov	219.1	0.4%	1.1%
CPI Core, Nov	221.9	0.1%	0.7%
PCE Core Defl, Nov	111.5	0.3%	1.0%
Gold, cash $/tr oz	1418.9	7.7%	29.5%
W Tx Int Cr Oil $/bbl	91.4	14.5%	14.8%
Copper	443.5	21.4%	33.3%
CRB Futures Ind	332.8	16.0%	31.1%

INDUSTRY		3 mo	12 mo
ISM Manuf Ind, Dec	57.0	2.6	1.1
ISM Services, Dec	57.1	3.9	7.0
Cap Utiliz, Nov	75.2%	0.5%	3.9%
Bldg Permits, Nov	544K	0.9%	–7.6%

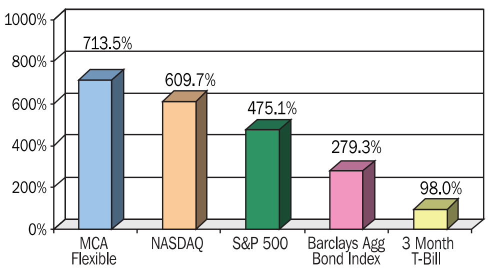
SALES		3 mo	12 mo
Total Retail-$B, Nov	378.7	3.5%	7.7%
Ttl ex Autos-$B, Nov	311.8	2.9%	6.7%
Autos-M Units, Dec	12.5	6.8%	12.6%
New Homes, Nov	290K	5.8%	–21.2%

LABOR – Dec '10		3 mo	12 mo
Unemployment Rate	9.4%	–0.2%	–0.5%
Non-Farm Jobs Chg.	103K	384K	1124K
Avg Init Unempl Clms	410K	–48K	–50K
Avg Hourly Wages	19.21	0.5%	1.9%

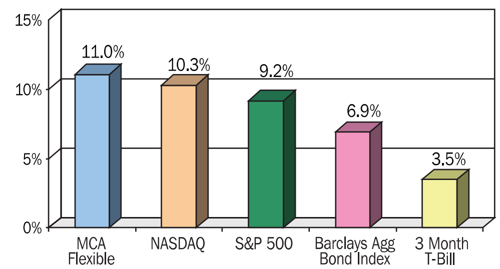
RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to December 31, 2010

Total Return



Annualized Return



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

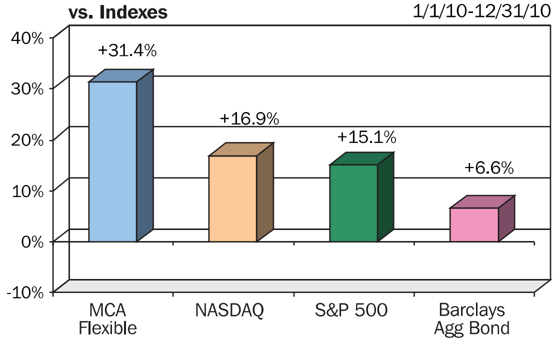
as of December 31, 2010

1	Apple	322.56	6	Ultra QQQ	81.43	11	SanDisk	49.86	16	iShares Russell 3000	74.95
2	Whole Foods Market	50.59	7	Charles Schwab	17.11	12	Cisco Systems	20.23	17	Intel	21.03
3	Oracle	31.30	8	Intuitive Surgical	257.75	13	Tiffany	62.27	18	Coach	55.31
4	Starbucks	32.13	9	Williams Sonoma	35.69	14	Caterpillar	93.66	19	Blackrock, Inc.	190.58
5	Omnivision Tech	29.61	10	Texas Instruments	32.50	15	Davita	69.49	20	NASDAQ Biotech Index	93.42

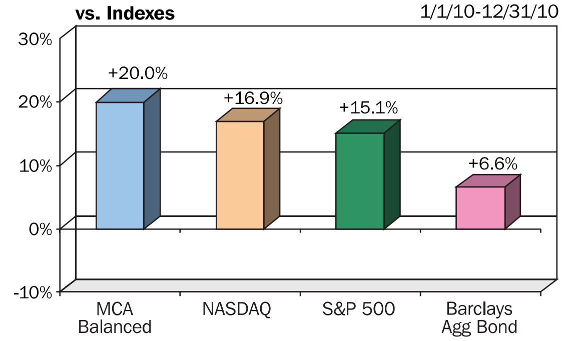
INVESTMENT RESULTS

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

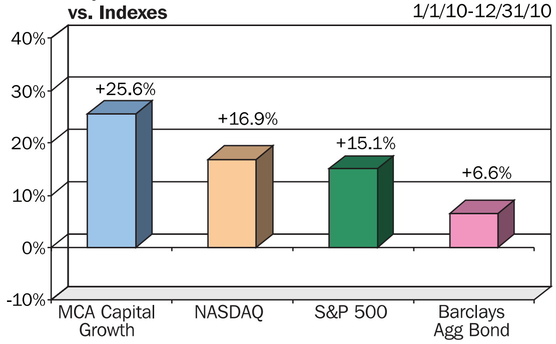
Flexible Portfolios vs. Indexes 1/1/10-12/31/10



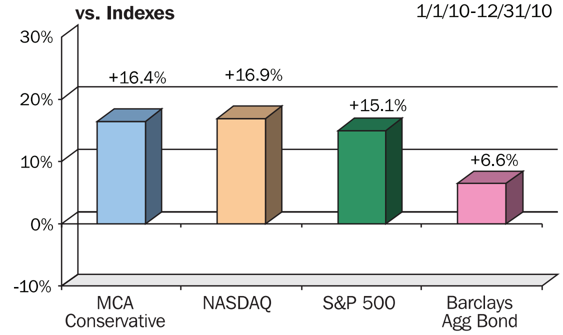
Balanced Portfolios vs. Indexes 1/1/10-12/31/10



Capital Growth Portfolios vs. Indexes 1/1/10-12/31/10



Conservative Portfolios vs. Indexes 1/1/10-12/31/10



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 22 individual portfolios and 30% of all funds under management by MCA on 12/31/10. 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.