THE COMPASS

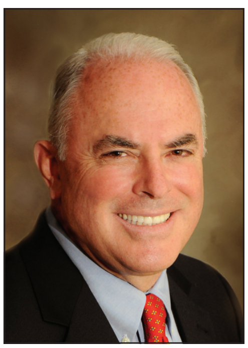
July 2011 A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Stocks are Resilient in the Face of Debt Ceiling Uncertainty

July 26, 2011

Stocks were resilient in the second quarter, holding on to most of their gains from the first quarter, even in the face of continuing debt ceiling uncertainty and a host of other issues. Bonds performed a bit better than stocks during the quarter, benefiting primarily from signs of slowing economic growth; however, bond market returns still lag the performance of the stock market year-to-date.

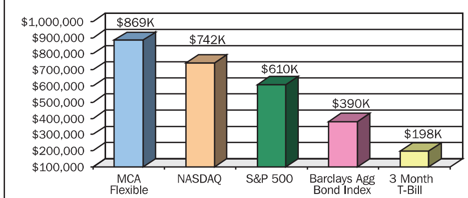


As we enter the third quarter, most stocks have rebounded significantly from the June correction lows and are at or near multi-year highs. Strong corporate earnings have been the primary catalyst for the latest advance, which also has been the primary driver of the bull market for the last two years. At this point, however, a five or ten percent correction, especially if the debt ceiling is not raised soon, could be in the cards.

Interestingly, if investors decide to worry more about seeking safety from the pending turmoil of the government not being able to meet many of its financial responsibilities, rather than worrying about whether government debt obligations will be paid, then Treasury bond prices in the near-term may react positively to the increasing risk of U.S. government insolvency. However, bond market strength should be used to reduce fixed income positions and stock market weakness should be viewed as a buying opportunity, since the debt ceiling will be raised eventually and any financial disruptions most likely will be short-lived and not have a material long-term effect on the economy.

Regardless of what happens with the debt ceiling in the short-term, most companies have the capability to remain on track for above average earnings growth because of strong balance sheets and high productivity. In other words, businesses today are structured to grow and prosper in weak economic conditions. When the economy returns to average or above average growth, which most economists and the Fed think probably will happen before the end of the year, then the ensuing corporate earnings surge could be the catalyst for the next significant stock market advance.

Growth of $100K
1/1/91–6/30/11



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COMPARISON OF INVESTMENT RESULTS

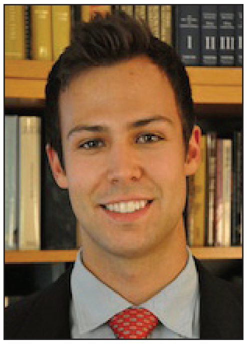
January 1, 1991 to June 30, 2011

	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]	768.9%	641.9%	509.8%	660.2%	559.7%	289.6%	98.1%	69.1%
Avg.[3]	11.1%	10.3%	9.3%	10.4%	9.8%	6.9%	3.4%	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]1991-2011 annualized return.

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

The U.S. economy slowed to an annualized growth rate of 1.8 percent in the first quarter from a much rosier 3.1 percent in the previous quarter. This slower rate of growth appears to have persisted into the second quarter, causing the Fed to lower its forecast for 2011 growth to between 2.7 and 2.9 percent from prior projections well above 3.0 percent. **(Figure 1)**



Although the private sector has continued to add jobs, the number of unemployed Americans has increased by over half a million since March, and is now over 14 million. This has pushed the unemployment rate from 8.8 percent in March to 9.2 percent today. June's employment report was particularly disappointing: economists' had expected the economy to gain 125,000 jobs, but only 18,000 jobs were added. In addition, the job gains reported in April's employment report were revised down to 217,000 from 232,000, and May's report was revised down to 25,000 from 54,000. **(Figures 2, 3, & 4)**

Manufacturing recorded its 23rd straight month of expansion in June, but has slowed since the beginning of the year. After topping 60, a very strong number, for the first four months of 2011, the ISM's Manufacturing Index fell to 53.5 in May, which was the biggest one-month drop since 1984. The sharp decline was attributed to high gasoline prices and the disruption in automaker supply chains caused by the March 11th earthquake in Japan. The index has since rebounded to 55.3 in June as these problems have improved. **(Figure 5)**

Disappointing labor market conditions and concerns over Washington reaching an agreement on the debt ceiling have weighed on consumer confidence. In July the University of Michigan Consumer Sentiment Index fell from 71.5 to 63.8. This marked a two-year low and was particularly disappointing because economists' had predicted the index would rise in July. The index is now down 13.7 points from the mark it reached in February and is only 8.5 points above the lowest level it reached during the recession. The Conference Board's Consumer Confidence Index also declined during the quarter falling in May and also in June to 58.5 points. Despite inflation fears subsiding, consumers' appraisal of present conditions is less favorable than earlier this year. **(Figure 6)**

This decline in confidence has weighed on retail sales. After posting strong growth earlier this year, retail sales growth has slowed in the second quarter. The numbers were mostly flat over the quarter – sales were up 0.1 percent in June after declining 0.1 percent in May – yet year-over-year sales are still up 8 percent. **(Figure 7)**

One recent bright spot in the economy has surprisingly been housing. In June, housing starts rose by 14.6 percent to a seasonally adjusted annual rate of 629,000 and year-over-year housing starts are up 16.7 percent. The jump in June was caused by a surge in multi-family housing starts. New building permits rose 2.5 percent in June to 624,000. However, housing reports have been a bit of a mixed bag as existing home sales fell 0.8 percent in June to a seven-month low. **(Figure 8)**

After rising fairly sharply earlier this year, June's Consumer Price Index dropped 0.2 percent, which was the first decline in nearly a year. The decline was mainly due to a fall in energy prices – gasoline, in particular, dropped 6.8 percent. Year-over-year the CPI has increased 3.4 percent. The cause of the increase has mostly been driven by energy and food prices, which have increased 20.1 percent and 3.7 percent in the past 12 months, respectively. Core CPI, which excludes food and energy, rose 0.25 percent in June, and is up 1.6 percent year-over-year. The Producer Prices Index, a measure of wholesale inflation, has moderated recently as energy prices have declined – falling 0.4 percent in June after rising 0.2 percent in May; however year-over-year the PPI is up 7.0 percent. The core PPI is continuing to steadily rise, moving up 0.3 percent in June for the seventh consecutive monthly advance, but is up just 2.3 percent year-over-year. **(Figure 9)**

Treasury bond yields declined in the second quarter and have continued to fall thus far into the third quarter. Despite the threat of a U.S. default and the increasing risk of credit agencies downgrading the AAA rating of U.S. Treasuries, yields are close to their 2011 lows. The 10-year Treasury is currently yielding below 3.0 percent compared to 3.47 percent at the close of the first quarter, primarily because of weaker economic conditions and a flight to quality in the face of economic uncertainty. **(Figure 10)**

The U.S. economy has again hit a soft patch in the recovery, similar to the one that occurred last summer, yet the U.S. growth rate remains the highest of the G-7 countries. As we head into the late summer and early fall, everyone is keeping a close eye on the economy to see if the pullback over the last few months will continue or if economic growth will accelerate again as it did last fall.

Figure 1

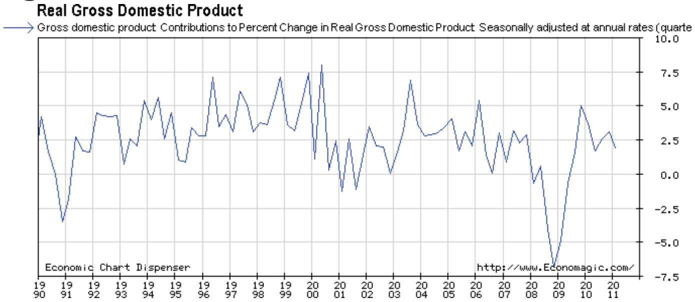


Figure 2

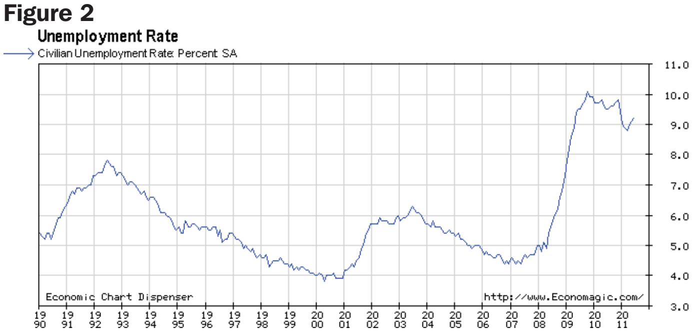


Figure 3

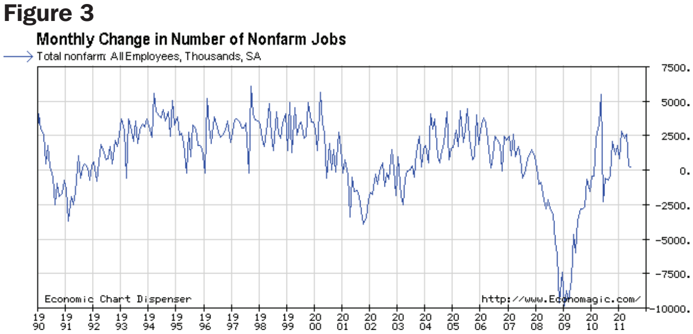


Figure 4

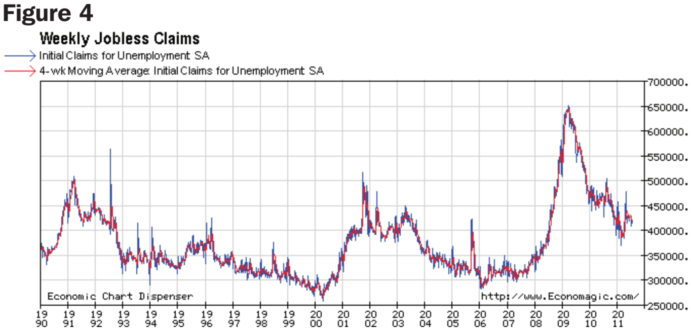


Figure 5

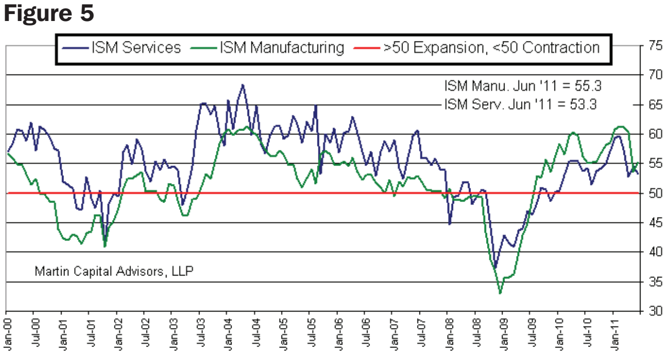


Figure 6

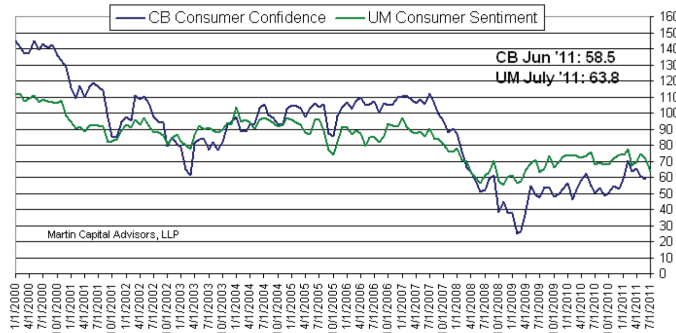


Figure 7

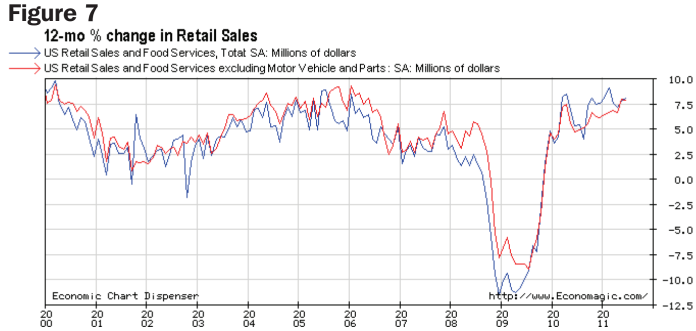


Figure 8

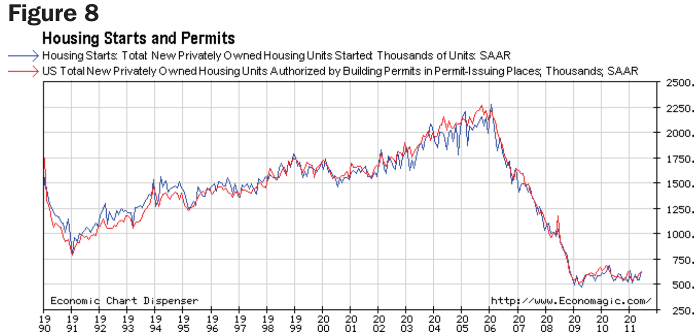


Figure 9

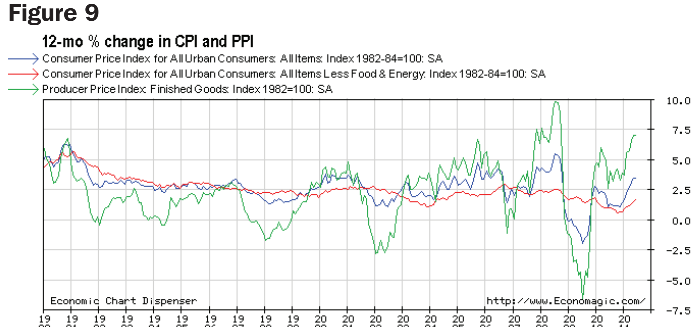
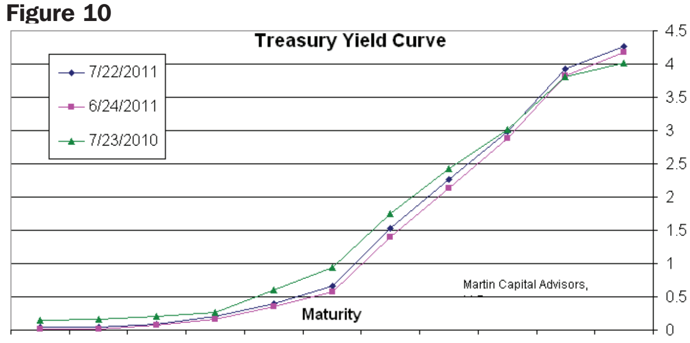


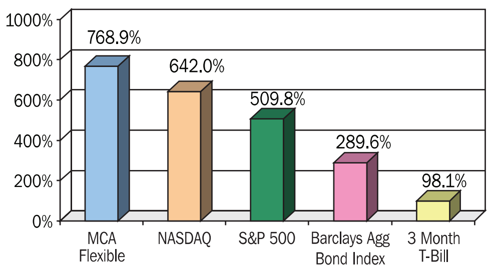
Figure 10



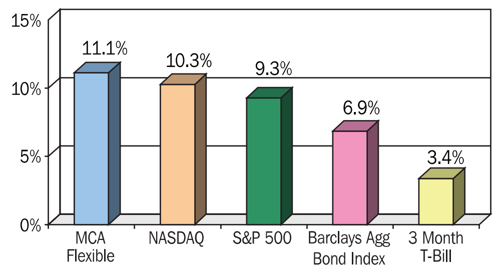
RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to June 30, 2011

Total Return



Annualized Return



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MARTIN CAPITAL ADVISORS, LLP
100 Congress Avenue, Suite 2000
Austin, Texas 78701
512-477-7036 • 877-477-7036

Martin Capital Advisors, LLP, is a registered investment advisor managing private and institutional investment portfolios. Independent performance reporting provided by Robert Harrell, Inc.

FLEXIBLE PORTFOLIO TOP 20 POSITIONS

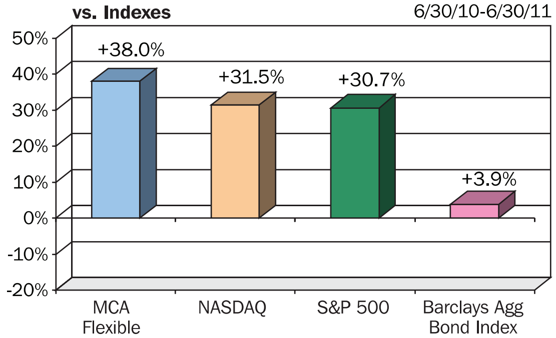
as of June 30, 2011

1	Apple	335.67	6	Texas Instruments	32.83	11	SanDisk	41.50	16	NASDAQ Biotech	106.66
2	Whole Foods Market	63.45	7	Tiffany	78.52	12	Caterpillar	106.46	17	Applied Materials	13.01
3	Oracle	32.91	8	Charles Schwab	16.45	13	Intuitive Surgical	372.11	18	Coach	63.93
4	Starbucks	39.49	9	Williams Sonoma	36.49	14	Davita	86.61	19	LAM Research	44.28
5	OmniVision Tech.	34.81	10	Intel	22.16	15	Cisco Systems	15.61	20	Advent Software	28.17

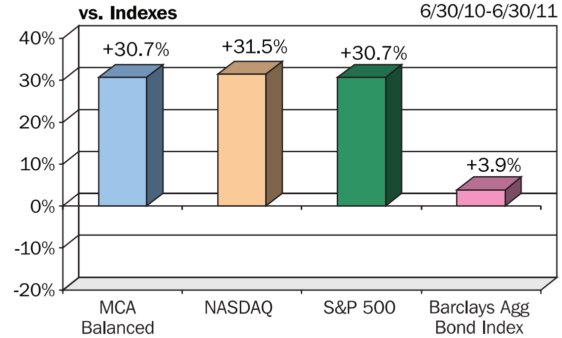
INVESTMENT RESULTS

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

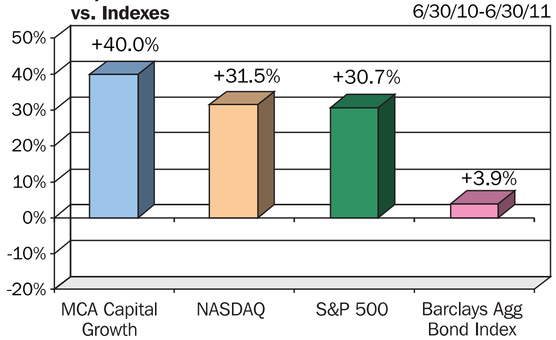
Flexible Portfolios vs. Indexes 6/30/10-6/30/11



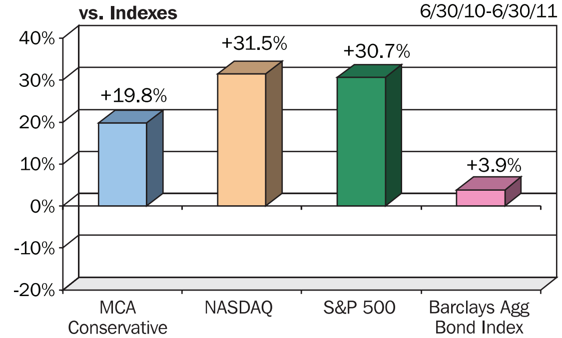
Balanced Portfolios vs. Indexes 6/30/10-6/30/11



Capital Growth Portfolios vs. Indexes 6/30/10-6/30/11



Conservative Portfolios vs. Indexes 6/30/10-6/30/11



IMPORTANT DISCLOSURE NOTICE: Past performance does not guarantee future results. Figures include the reinvestment of all dividends received and reflect cash and cash equivalents and are net of all fees and expenses; 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 6/30/11. 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.