THE COMPASS

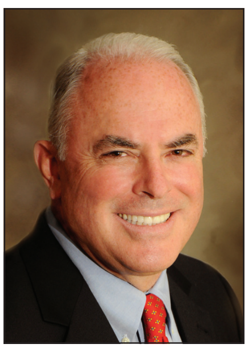
January 2012 A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Stocks Rally in Fourth Quarter as Economic Expansion Picks Up Steam

January 25, 2012

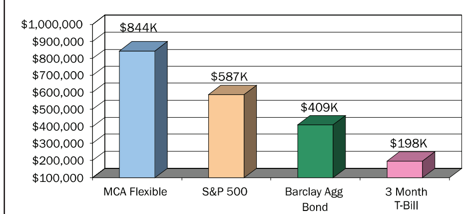
The stock market rebounded in the fourth quarter as most economic indicators continued to improve, resulting in positive returns for the year for the major U.S. stock market indexes. The economy and the stock market were amazingly resilient in the face of tsunamis, earthquakes, political battles, wars, insurgencies, debt downgrades, budget deficits, the European debt crisis and fears of economic contraction in China. Bond prices managed slight gains for the quarter and solid gains for the year, despite nascent signs that core inflation may be gaining a foothold in the economy.



The New Year has gotten off to a good start with stocks advancing on positive economic reports and generally solid corporate earnings. Bond prices have weakened slightly in response to improving economic conditions. The strength in stocks and weakness in bonds most likely will continue throughout the year; however, in light of the significant stock market advance from the October lows, the odds of a short-term stock market correction are increasing. My guess is that stocks may give back some of their gains in the near future, but that they will be somewhat higher by the end of the quarter.

Although many of the problems that weighed on the economy and the stock market in 2011 will not go away in 2012, there is a good chance that they will at least start to show signs of improvement as the year progresses. If that happens, then 2012 could prove to be a very good year for stocks. In the event that the headwinds persist or even get worse, then low stock market valuations should buoy returns as they did in 2011. Consequently, the risk/reward ratio for stocks remains quite attractive. Bonds, on the other hand, have a very poor risk/reward ratio and should be held in diversified investment portfolios only for defensive purposes.

Growth of $100K
1/1/91–12/31/11



See details and important Disclosure Notice on last page.

The decades following the weak stock market performances of the 1930s and 1970s were quite good for stocks, but for opposite reasons. After the deflation of the 1930s, the reflation that followed benefited stocks, but hurt bond returns for almost 30 years; and after the high inflation of the 1970s, disinflation stimulated both stock and bond returns for almost twenty years. Today, after a deflationary decade that was worse for stocks than the 1930s, the U.S. economy appears to be on the verge of a reflation similar to the one that occurred after the Great Depression. If reflation does occur, then bonds could be entering a secular bear market and stocks could be entering a secular bull market that might last for decades.

COMPARISON OF INVESTMENT RESULTS

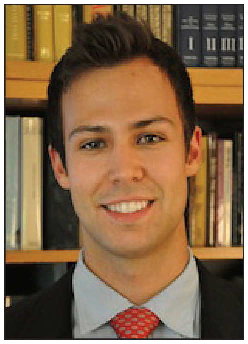
January 1, 1991 to December 31, 2011

	Martin Capital Advisors[1]	S&P 500	Wilshire 5000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
Total[2]	743.7%	487.2%	528.1%	308.9%	98.1%	65.7%
Avg.[3]	10.7%	8.8%	9.2%	6.9%	3.3%	2.4%

[1]Total 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 final numbers for GDP showed that the U.S. economy grew at an annualized rate of 1.8% for the third quarter 2011, an increase over the second quarter's 1.3% gain. GDP for the fourth quarter is projected to be around 3%. The fears of a double-dip recession that flared up in August were alleviated as economic data during the second half of 2011 showed an improvement in the job market, rising consumer and business spending, and even some improvement in the housing market. **(Figure 1)**



The economy added 200,000 jobs in December, led by an increase of 325,000 jobs in the private sector. The number of jobs added in December was 50% higher than the monthly average in 2011 and was broadly distributed across multiple sectors. The economy has added at least 100,000 new jobs for five months in a row, which is the longest streak since 2006. This has pushed the unemployment rate down to 8.5%: the lowest rate in 3 years. Further declines in the unemployment rate may be more difficult to achieve as discouraged workers who have given up searching for work are lured back to reentering the labor force by an improving job market. **(Figures 2, 3, & 4)**

The ISM Manufacturing index expanded to 53.5 in November, led by a reading of 57.6 for the index for new orders, which points to strong growth in manufacturing. Earlier in the year, there were worries that manufacturing may slow down as the new orders component fell for two consecutive months below the 50-mark that indicates contraction. The slowdown in Europe could hurt manufacturing as Europe receives 22% of U.S. exports, but this shouldn't derail the U.S. economy as exports only account for 15% of GDP. The Non-Manufacturing index registered 52.6 in December, 0.6% higher than in November, but below expectations and well below readings recorded earlier in the year. **(Figure 5)**

Retail sales have steadily grown during the second half of 2011 and are up 6.7% compared to a year ago. 2011 holiday sales were strong and were helped by a 16.4% increase in sales during Black Friday weekend. Auto sales have also recorded strong numbers and are averaging an annualized rate of 13.4 million units per month. **(Figure 6)**

Improving economic data has coincided with improving confidence. The Conference Board Consumer Confidence Index rose to 64.5 in December, up from 55.2 in November, and 40 in October. The index is now near its post-recession peak of 72 reached in February 2011. The University of Michigan Consumer Sentiment beat expectations and rose to 69.9 from 64.1 in November. Increased confidence has been attributed to a better than expected labor market and falling gasoline prices. **(Figure 7)**

There have been several reports lately that have provided reasons to believe that the housing market has finally bottomed and is beginning to rebound. Sales of single-family existing homes rose 4% in November and are up 12% for the year. Housing starts were up 9.3% in November, which was the best month since April 2010. Despite the gain, housing starts for the year were the lowest since recordkeeping began in 1959. Building permits increased to an annual pace of 681,000, which was the highest level since March 2010. The Case-Schiller Home Price Index is down 3% for the year, but this shows that prices have almost stabilized, which is significant considering prices have fallen 33% since 2006. **(Figure 8)**

Inflationary pressures have recently eased. The Consumer Price Index fell 0.1% in October and was flat in November after hitting an annual rate of 3.9% in September. The decline has been attributed to falling energy and gasoline prices. For the year, consumer prices have risen 3.4%, with core CPI up 2.1%. Wholesale prices, measured by the Producer Price Index, have also fallen since September and were up 6% for the year. **(Figure 9)**

The yield curve remains steep as the Fed continues to keep the Federal Funds rate between 0 and 0.25%, which it has done for the past three years. The Fed is expected to continue to pursue the "Operation Twist" policy it announced in September. This policy was enacted to push down long-term interest rates by selling medium-term bonds and buying long-term debt. The policy has been successful and is one reason why 30-year mortgage rates continue to trend below 4 percent and 10-year Treasury Notes remain around 2 percent. **(Figure 10)**

The U.S. economy has entered 2012 with momentum – consumers are more optimistic, the labor market is improving, and the housing market is finally showing signs of a bottom, yet we still haven't seen GDP growth reflect a strong recovery. This makes the positive economic momentum that we have experienced so far susceptible to outside forces, which is one reason why we saw such dramatic market volatility during the second half of 2011.

Figure 1

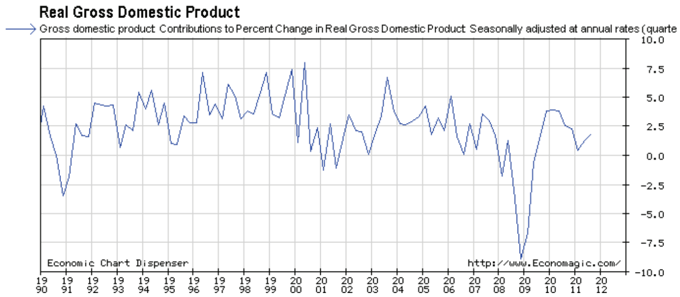


Figure 2

Figure 3

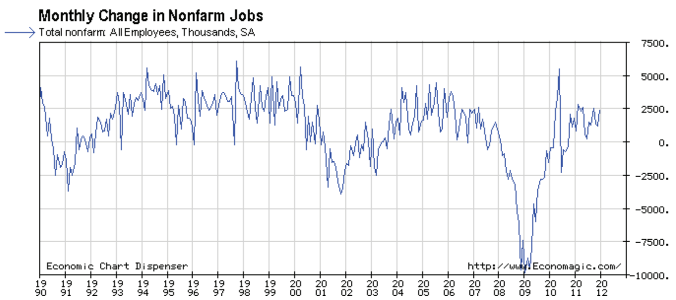


Figure 4

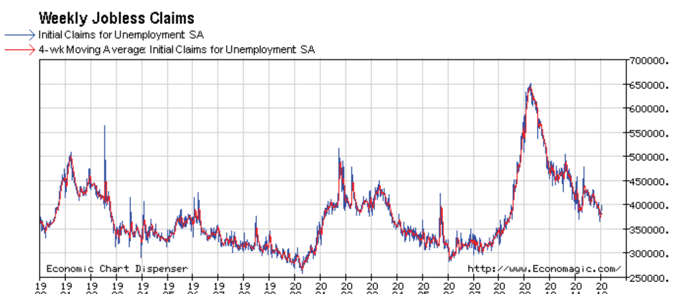


Figure 5

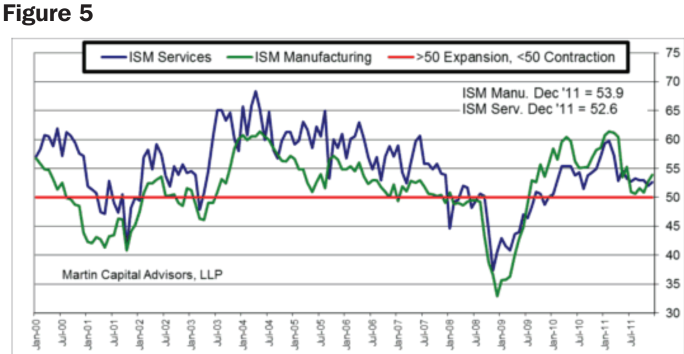


Figure 6

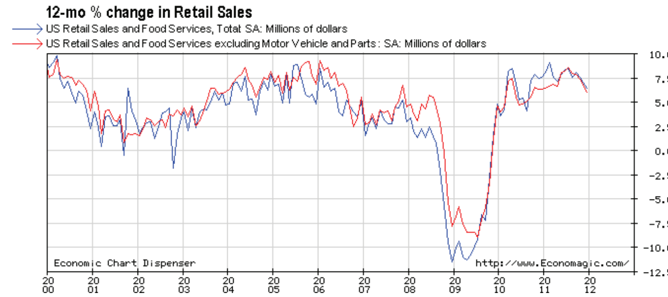


Figure 7

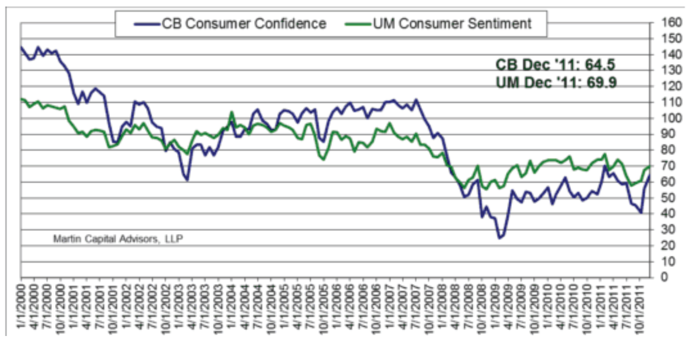


Figure 8

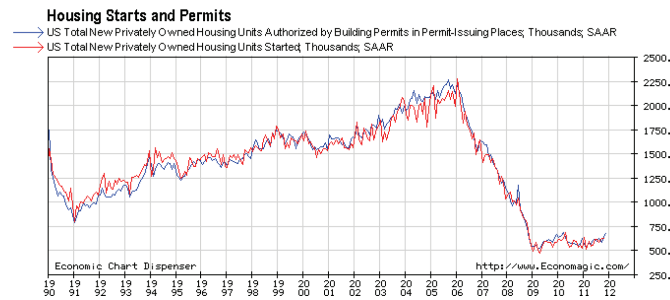


Figure 9

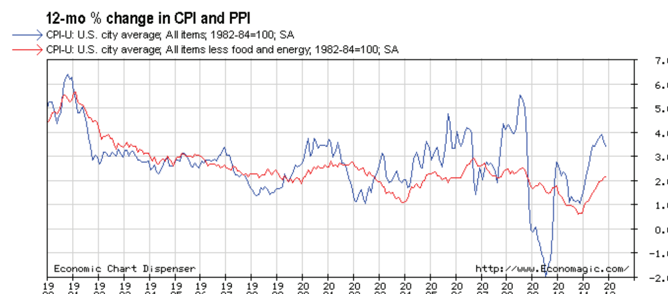
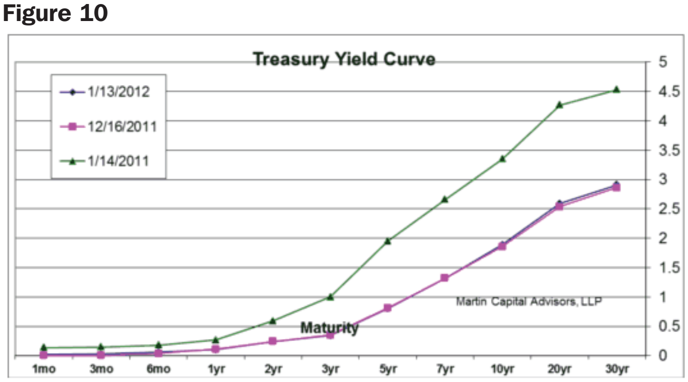


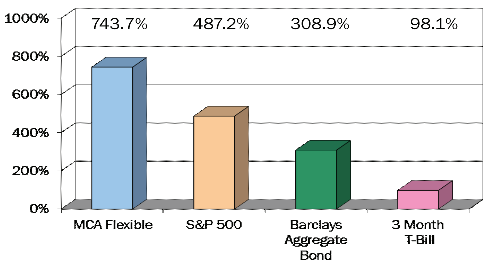
Figure 10



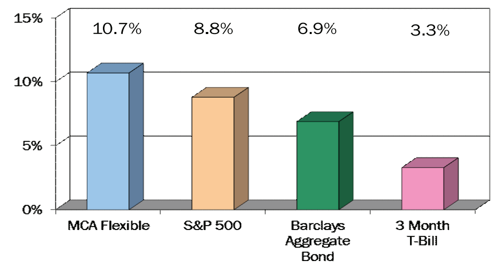
RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to December 31, 2011

Total Return



Annualized Return



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Martin Capital Advisors, LLP, is a registered investment advisor managing private and institutional investment portfolios. Independent performance reporting provided by CGM Investment Management.

FLEXIBLE PORTFOLIO TOP 20 POSITIONS

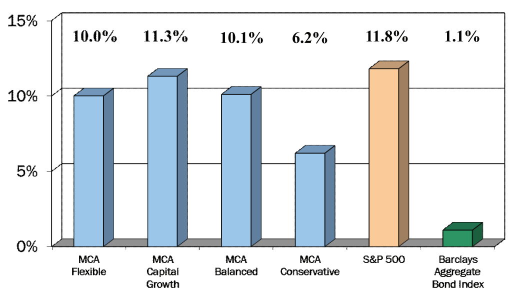
as of December 31, 2011

1	Apple	405.00	6	Intel	24.25	11	Intuitive Surgical	463.01	16	Coach	61.04
2	Whole Foods Market	69.58	7	Tiffany	66.26	12	Cisco Systems	18.08	17	NASDAQ Biotech Index	104.35
3	NASDAQ 100 ETF	55.83	8	Williams Sonoma	38.50	13	Charles Schwab	11.26	18	Applied Materials	10.71
4	Starbucks	46.01	9	SanDisk	49.21	14	Caterpillar	90.60	19	OmniVision Technologies	12.24
5	Oracle	25.65	10	Texas Instruments	29.11	15	Davita	75.81	20	Advent Software	24.36

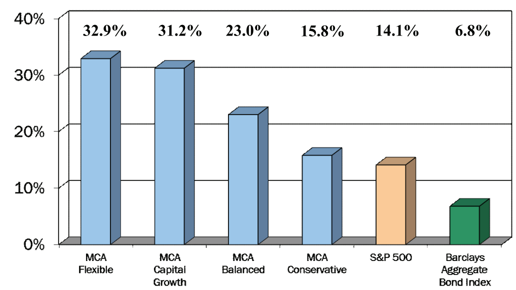
INVESTMENT RESULTS

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

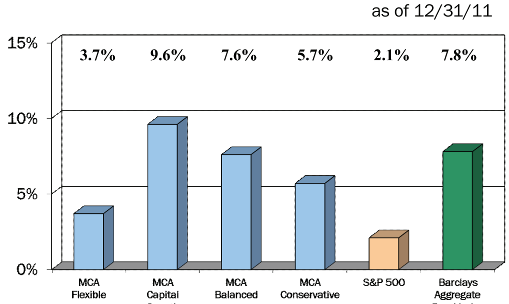
Three-Month Returns
as of 12/31/11



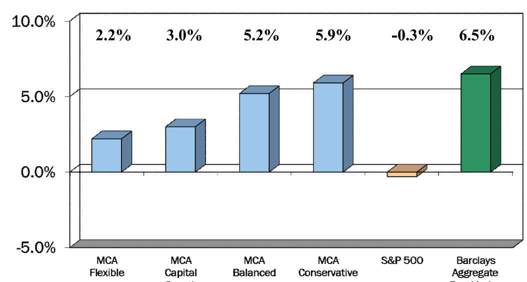
Three-Year
Annualized Returns
as of 12/31/11



One-Year Returns
as of 12/31/11



Five-Year
Annualized Returns
as of 12/31/11



Important Disclosure Notice: Past performance does not guarantee future results. Figures include the reinvestment of all dividends received and reflect cash and cash equivalents. Martin Capital Portfolios returns are net of all fees and expenses. From time to time, portfolio performance may reflect the use of margin investing, as well as material investments in bonds and cash, and volatility may differ from that of the benchmark. As of 12/31/2011, the *MCA Flexible/Capital Growth/Balanced/ Conservative/Enhanced ETF Portfolios* returns represent, respectively, 21/7/3/3/1 individual portfolios and 30%/37%/26%/6%/1% of all funds under management by MCA. Clients explicitly elect these management styles on their Personal Data Form. The *Flexible, Capital Growth and Enhanced ETF Portfolio*s are managed for capital appreciation, and the *Balanced and Conservative Portfolios* are managed for capital appreciation and income.

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.