THE COMPASS

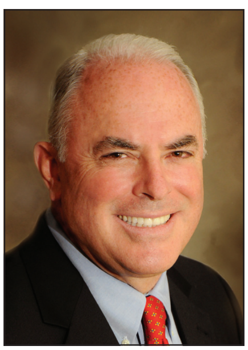
July 2012 **A Quarterly Newsletter of Martin Capital Advisors, LLP**

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

2nd Quarter Market Correction Cuts into 1st Quarter Gains, but Year-to-Date Returns Remain Positive

July 24, 2012

The possible correction discussed in the last newsletter unfolded in the second quarter, with major stock indexes declining about ten percent off their highs and then regaining roughly half of their losses by the end of the quarter. Bonds rallied slightly in the second quarter as a number of weaker economic reports suggested that the economy is losing some steam. In particular, manufacturing and employment showed signs of giving up much of the upward momentum established in the first quarter.



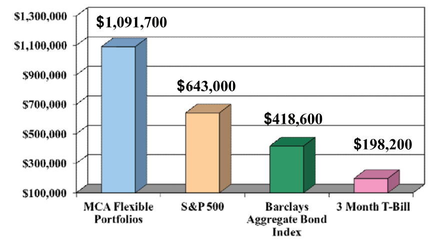
As we enter the third quarter, returns on stocks are fairly flat, while bond prices have continued to advance incrementally. Once again, better than expected earnings so far this quarter have helped stocks to hold their own in the face of European uncertainty, weakness in China and deteriorating U.S. economic conditions. Whether stronger than expected earnings prevail throughout the rest of the quarter remains to be seen. My best guess, however, is that low valuations will continue to put a floor under stocks – keeping corrections from expanding into full-fledged bear markets – and that any indications of economic strength eventually will drive prices higher, as occurred last fall through this spring. Bonds, on the other hand, are extremely expensive, so further economic deterioration will probably not contribute to significantly higher prices, but better economic data could hit bond prices hard. Consequently, stocks continue to have a much better risk/reward ratio than bonds.

There has been a lot of movement out of stock mutual funds and into bond funds over the past several years, even as stocks have outperformed bonds. Interestingly, most investors' perception seems to be that stocks have remained in a bear market and that bonds have outperformed stocks, which is the opposite of how these markets have performed since 2009. In fact, the S&P 500 Index has been in a bull market and has outperformed the Barclays Aggregate Bond Index by more than twofold over the past three years, based on total returns as of the end of June: 57.7% to 22.3%, respectively.

What's even more interesting is the huge amount of cash most investors, both individual and institutional, are holding in their "investment" portfolios – earning a paltry 0.4% since 2009 (the total return on three-month T-bills) and missing out on the stock and bond market advances mentioned previously. During the same time frame, inflation, as measured by the Consumer Price Index, has increased 9.3%, so the real return on cash has been -8.9%. Admittedly, cash did not go down in 2008, the worst year for the S&P 500 since 1931; however, the five-year return for the S&P 500 Index through June 30, 2012, which includes 2008, is now better than the three-month T-bill return.

To sum it up: (1) Cash is a bad investment, since real returns are often negative, as shown above, and over the long run, returns are barely break-even, adjusted for inflation; (2) Bonds generally perform better than cash, but their low yields today present an unusually high risk, especially in light of the Federal Reserve's implicit goal to reflate the economy; and (3) Stock valuations are low, and, relative to bonds and interest rates, they are as cheap as they have ever been. So the likelihood is high that stocks will continue to outperform bonds and cash for at least the next few years, as they have for the last three years and over the long run.

Growth of $100K
1/1/91–6/30/12



See details and important Disclosure Notice on last page.

COMPARISON OF INVESTMENT RESULTS

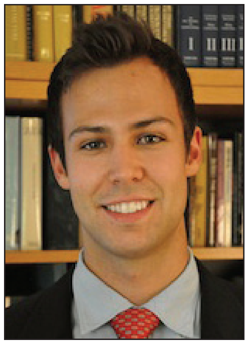
January 1, 1991 to June 30, 2012

	Martin Capital Advisors[1]	S&P 500	Wilshire 5000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
Total[2]	991.7%	543.0%	585.6%	318.6%	98.2%	71.8%
Avg.[3]	11.8%	9.0%	9.4%	6.9%	3.2%	2.6%

[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]1991-2012 annualized return.

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

Real gross domestic product advanced at an annualized rate of 1.9 percent in the first quarter of 2012, decelerating from the 3 percent growth rate recorded in the previous quarter. On a year-over-year basis the economy has grown 2.0 percent. A string of weaker than expected economic data, including employment data and manufacturing orders, has caused the Fed to lower its GDP forecast for 2012 and 2013 to below 3 percent, which is the level typically associated with healthy economic growth. **(Figure 1)**



U.S. non-farm payrolls rose less-than-expected last month, causing many to fear that the U.S. economy may be slowing down. Non-farm payrolls added 80 thousand jobs, a slight increase from the upwardly revised number of 77 thousand recorded in May. The economy has only added 225 thousand jobs in this past three months; this is an annual pace of 900 thousand jobs. To put that number in perspective, in 2011 the economy added 2.1 million jobs. While the numbers show tepid job growth, they may appear worse than reality. The household survey, which typically does a better job of accounting for job growth by small businesses, reported that the economy added 128 thousand jobs in June, while the unemployment rate remained at 8.2 percent. **(Figure 2, 3, & 4)**

As India and China show signs of slowing down and Europe continues to sputter, U.S. manufacturing is beginning to show some signs of weakness. The ISM manufacturing index dropped to 49.7 in June from 53.5 in May. This is the first time since July 2009 that the reading has dropped below the 50-mark that indicates contraction. In June the ISM Non-manufacturing index was at 52.1 percent, down from 53.7 percent in May. **(Figure 5)**

July's preliminary report for the UM Consumer Sentiment Index revealed that consumers' views of the economy are weakening. The reading came in at 72.0, down from 73.2 in June, and below the consensus forecast of 73.5. Fading employment numbers and a sluggish economy have begun to dampen consumer optimism, which reached a one-year high in the spring. **(Figure 6)**

Declining optimism is coinciding with a decrease in consumer spending. In May retail sales posted a 0.2 percent decline, following a similar decline in April, and the results in June are expected to follow suit. Auto sales, on the other hand, have continued to perform well. Sales were at a seasonally adjusted rate of 14.08 million in June, which is 22 percent higher than a year ago, and is 2.6 percent higher compared to May. **(Figure 7)**

After lagging behind other sectors, the housing market, which is traditionally a leading indicator of both recessions and recoveries, is now the bright spot in the economy. Single-family housing starts increased 3.2 percent to 516 thousand in May, and April's numbers were revised upward. Existing home sales dropped 1.5 percent in May, but are still 9.6 percent higher than a year ago, and home prices continue to trend upwards. New Home Sales increased 7.6 percent in May to a seasonally adjusted rate of 369 thousand homes. This rate was the best pace since April 2010. The increase in new home sales coincided with an increase in construction spending, which rose 0.7 percent in May and is 7 percent higher than a year ago. **(Figure 8)**

Problems in Europe and slowing growth in some emerging economies have caused sharp declines in commodity prices. These declines coupled with a slowly recovering labor market have kept inflationary pressures in check. The Consumer Price Index (CPI) decreased 0.3 percent in May and core prices were down 0.2 percent. Compared to a year ago, the CPI is up 1.7 percent, and producer prices are up 0.7 percent. Low inflation and disappointing economic data has caused many economic speculators to believe that the Fed may go for a third round of quantitative easing to help stimulate the economy, but there has been little evidence from Fed meetings that a third round of easing is on the table. **(Figure 9)**

The escalation of the financial crisis in Europe during June caused a flight to safety in U.S. Treasury securities and brought yields on 10-year Treasuries to historical lows. This flattening of the yield curve tends to coincide with a strengthening of the dollar, which makes U.S. exports less attractive and weighs on manufacturing. **(Figure 10)**

As we look to the second half of the year, the U.S. economy is in the strongest position of all major economies. Everyone is wondering, however, if the rest of the world will bring the U.S. down, or will strong balance sheets, solid earnings, and pent up demand, along with an improving housing market, be able to drive growth sufficiently to sustain the U.S. recovery.

Figure 1

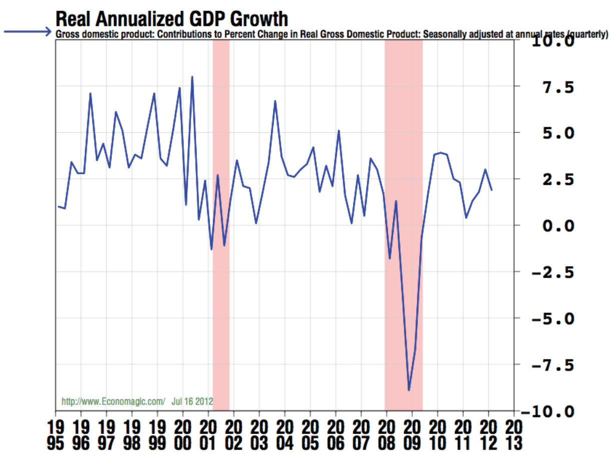


Figure 2

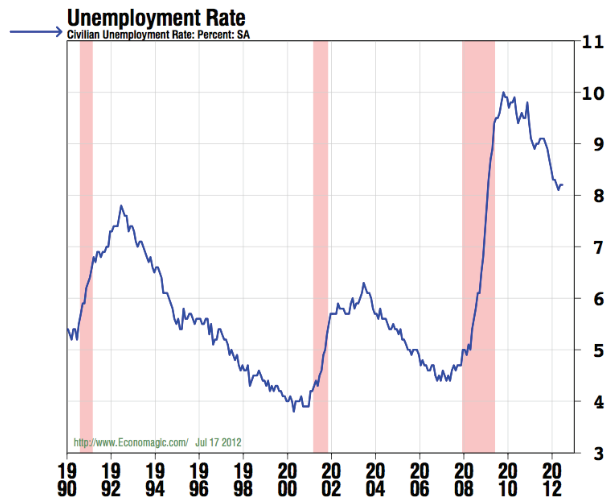


Figure 3

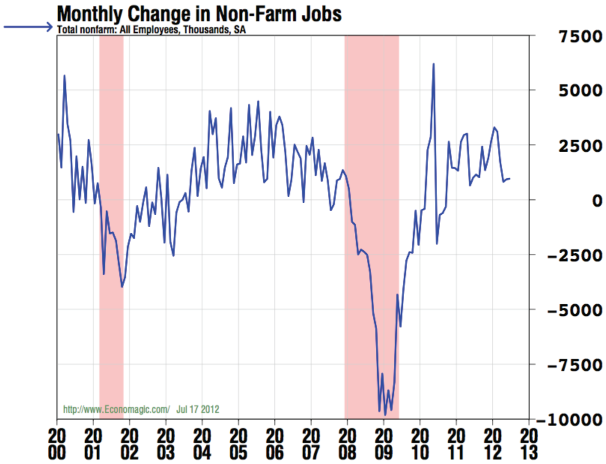


Figure 4

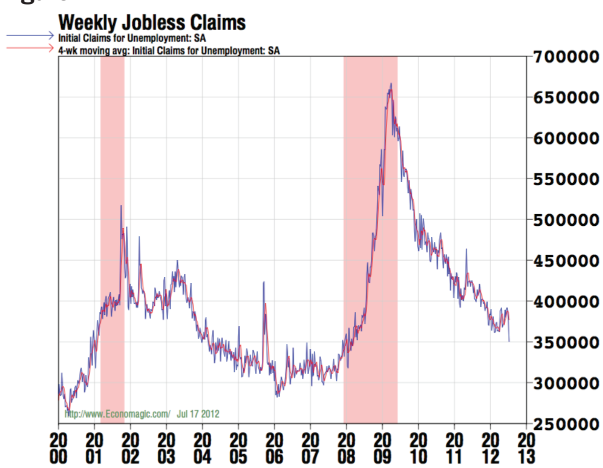


Figure 5

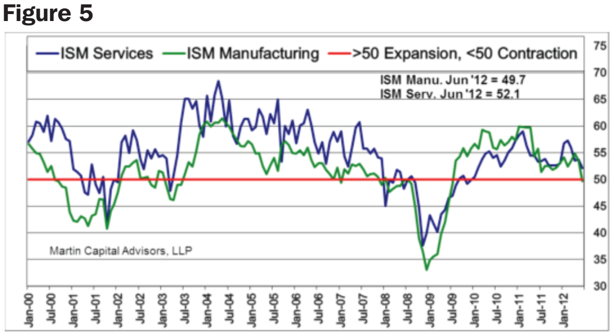


Figure 6

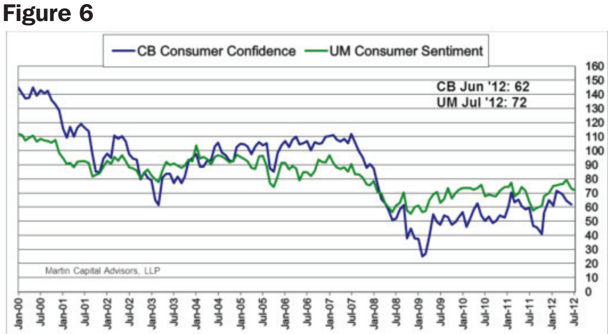


Figure 7

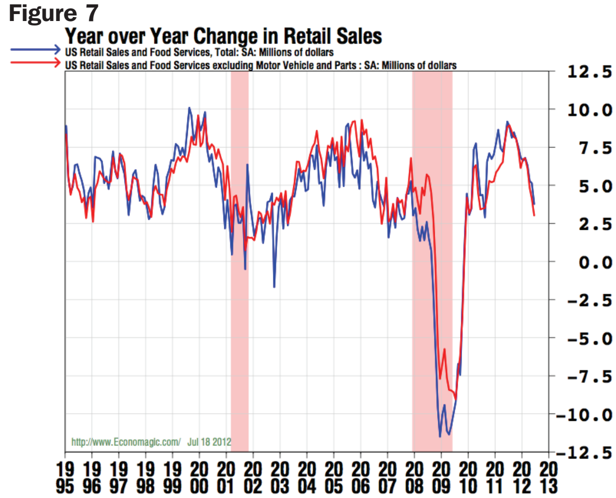


Figure 8

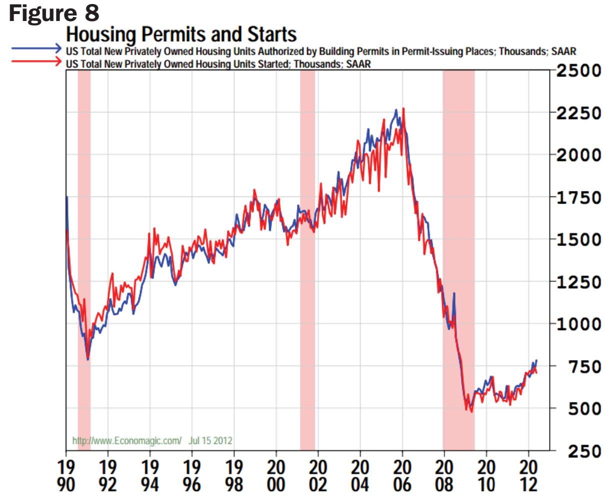


Figure 9

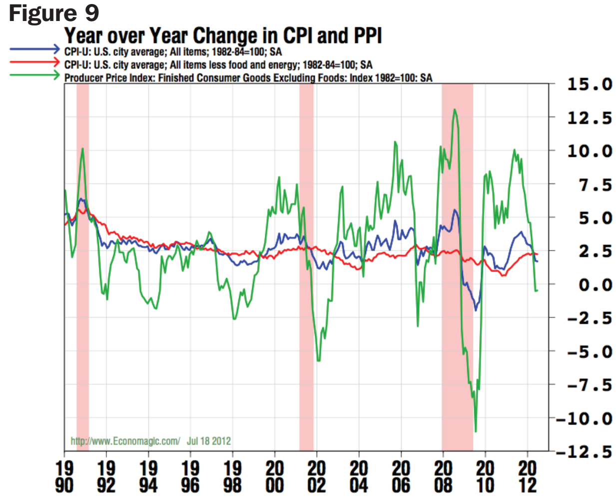
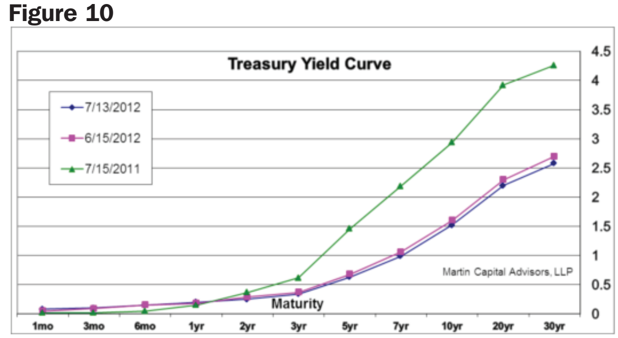


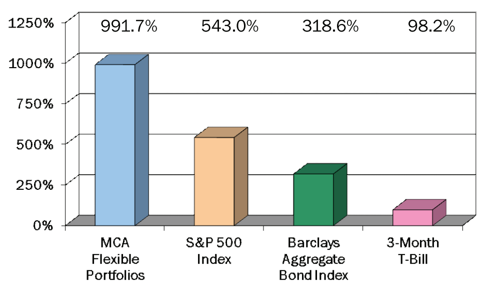
Figure 10



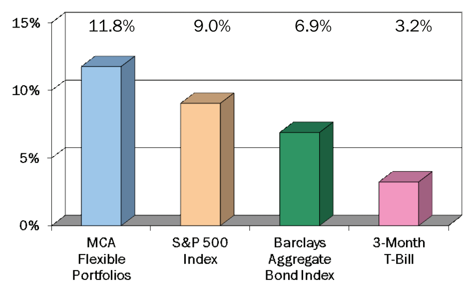
RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to June 30, 2012

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.

MCA FLEXIBLE PORTFOLIOS TOP 20 POSITIONS

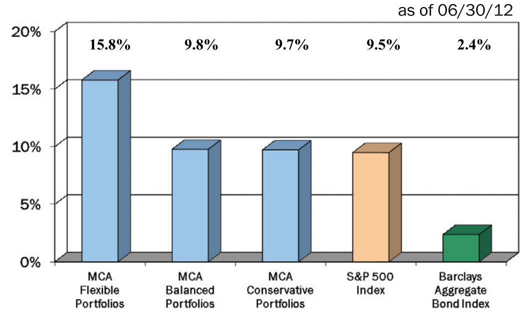
as of June 30, 2012

1	Apple	584.00	6	Oracle	29.70	11	Tiffany	52.95	16	SanDisk	36.48
2	Whole Foods Market	95.32	7	Davita	98.21	12	NASDAQ Biotech Index	129.955	17	Mastercard	430.11
3	Starbucks	53.32	8	Williams-Sonoma	34.97	13	Caterpillar	84.91	18	SPDR S&P 500 ETF	136.105
4	Intuitive Surgical	553.79	9	Intel	26.65	14	Charles Schwab	12.93	19	OmniVision Technologies	13.34
5	NASDAQ 100 ETF	64.16	10	Texas Instruments	28.69	15	Cisco Systems	17.17	20	Peet's Coffee & Tea	60.04

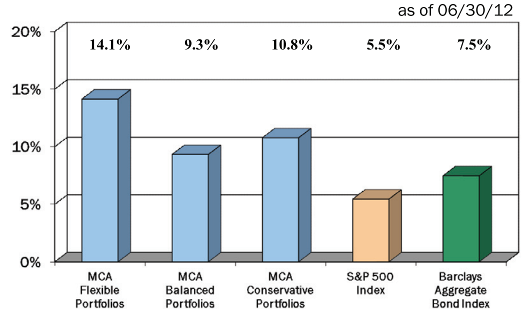
INVESTMENT RESULTS

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

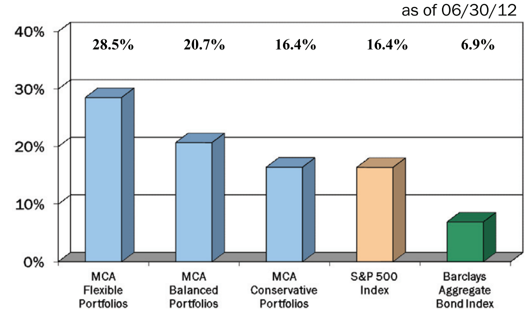
Year-to-Date Returns
as of 06/30/12



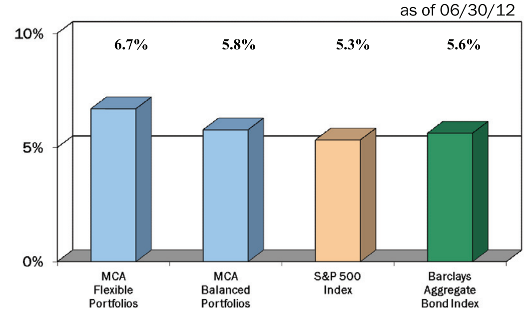
One-Year Returns
as of 06/30/12



Three-Year
Annualized Returns
as of 06/30/12



Ten-Year
Annualized Returns
as of 06/30/12



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 and options, as well as material investments in bonds and cash, and volatility may differ from that of the benchmark. As of 06/30/2012, the *MCA Flexible/ Balanced/Conservative/Enhanced ETF Portfolios* returns represent, respectively, 28/4/2/3 individual portfolios and 66%/29%/4%/1% of all funds under management by MCA. Clients explicitly elect these management styles on their Personal Data Form. The *MCA Flexible and Enhanced ETF Portfolios* are managed for capital appreciation, and the *MCA 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.