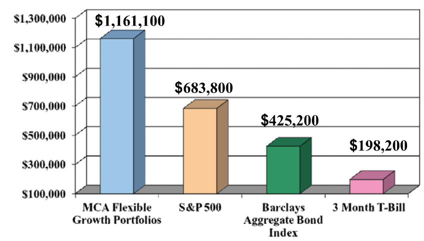
THE COMPASS

October 2012 — A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Stocks Rebound in the Third Quarter – Hitting New Recovery Highs

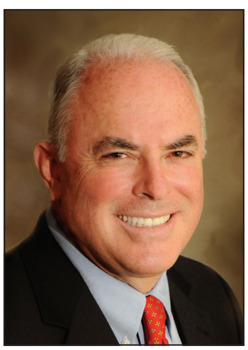
Growth of $100K
1/1/91–9/30/12



See details and important Disclosure Notice on last page.

October 22, 2012

The stock market rebounded in the third quarter as concerns about Europe moderated and earnings reports once again were better than expected. Fixed income returns also were positive, despite signs of higher inflation, largely due to the Federal Reserve's bond buying program. Year-to-date stock market returns are strong, with the S&P 500 up over 16% through the end of September. Fixed income returns are fairly moderate so far this year, as reflected in the Barclay's Aggregate Bond Index gain of only 4%.



Fourth quarter returns for both stocks and bonds are flat three weeks into the quarter. At this point, the forces that could drive the stock market higher in the near-term seem well-balanced with the forces that could take it lower, so there is a moderate risk that some of the recent gains could be given back before the bull market resumes. My best guess is that we will see some further "backing and filling," that is, somewhat lower prices, through the November elections, and then, regardless of the outcome, another advance into the end of the year. Bond prices should continue to be buoyed by the Fed's QE3 purchases, but returns most likely will remain lackluster.

Earnings season is now well underway and to date the numbers have painted a mixed picture relative to expectations. There is no doubt, however, that earnings growth weakened in the third quarter. The question is how much of the decline is already factored into stock prices. I think that the answer is probably to a large degree, but there is still some risk over the next month or so that disappointing reports could be a catalyst for lower prices. Nevertheless, once earnings season is over, the focus will shift to fourth quarter results, which are likely to be much better based on improving signs of underlying economic fundaments, such as retail sales, and this should give a lift to stocks through the end of the year.

Europe and the "fiscal cliff" are wild cards that could influence stock prices, but any negative impact most likely would be short-lived, as has been the case with the European financial crisis and U.S. fiscal shocks over the last few years. Contrary to popular opinion, there is a good chance that problems in Europe will not significantly flare up again, at least for a while, and that the realistic worst case scenario for the fiscal cliff is that it just gets kicked down the road – so once we get past earnings season and the elections the risk/reward ratio for stocks should improve quite a bit.

The bottom line: while there is risk in the short-term that stock prices could decline, I don't believe that the risk of a major correction is great, and longer-term stock prices still have the potential for greater gains.

COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to September 30, 2012

	Martin Capital Advisors[1]	S&P 500	Wilshire 5000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
Total[2]	1061.1%	583.8%	627.1%	325.2%	98.2%	72.2%
Avg.[3]	11.9%	9.2%	9.6%	6.9%	3.2%	2.5%

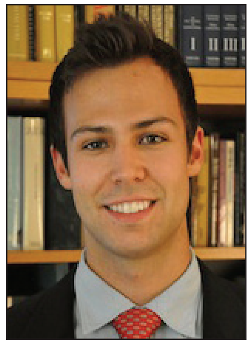
[1]Total performance, net of commissions, fees, and expenses of all Martin Capital Advisors' *Flexible Portfolios.*
[2]Total compounded return, including reinvestment of dividends and interest. [3]1991-2012 annualized return.

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

QUARTERLY ECONOMIC REVIEW by Colton Krueger, Economic Analyst

October 12, 2012

Real annualized Gross Domestic Product grew at a rate of 1.3 percent in the second quarter. This was weaker than expected, and is the second lowest growth rate since the recession ended in 2009. The low GDP rate confirmed that the economy hit a soft spot earlier this year, but recent data suggests that the U.S. economy may be improving, despite the slowdown in the worldwide economy. **(Figure 1)**



In September's employment report, the unemployment rate unexpectedly dropped from 8.1 percent to 7.8 percent. This occurred even with a slight increase in the labor participation rate. The reason for the sharp decline was due to a huge increase in employment reported by the Household Survey, not because of strong job growth observed in the Payroll Survey. The Household Survey announced that the economy added 873,000 jobs in September, which is the strongest one-month gain since 1983. While the Payroll Survey reported that 114,000 jobs were added, which is actually below the 2012 monthly average rate of 133,000. **(Figure 2, 3, 4)**

After three consecutive months of contraction, the ISM manufacturing index posted a reading of 51.5 in September, an increase of 1.9 percentage points from August. The report was much better than expected, and was led by a 5.2 percentage point increase in the New Orders component. The ISM Services report was also better than expected, posting a reading of 55.1, which is the highest number since March. **(Figure 5)**

Consumer's feelings about the economy are rebounding from their summer slump. The Conference Board Consumer Confidence Index now stands at 70.3, up from 61.3 in August, which was the lowest reading since November 2011. October's preliminary report from the University of Michigan Consumer Sentiment index showed that consumer optimism reached 83.1 – the highest reading in five years. **(Figure 6)**

While consumer's attitudes have been up and down in the latter half of 2012, consumer's actions reveal that they are spending more. Vehicle sales rose to an annualized rate of 14.9 million in September, the highest rate in more than four years, surpassing the spike in sales recorded during the cash for clunkers program. Retail sales rose 0.9 percent in August and are 4.4 percent higher compared to a year ago. **(Figure 7)**

Housing also continues to rebound. Existing home sales in August were up 7.8 percent compared to July. Housing starts rose 2.3 percent in August, driven by the fastest pace in single-family home construction in two years. Building permits were down 0.1 percent from the four year high they reached in July. However, housing is not a considerable driver of GDP growth. The primary impact an improving housing market has on GDP is a psychological effect: if consumers see that housing prices are improving, then they are more willing to spend. So far, housing prices have moved up modestly, with the Case-Shiller Index up 1.2 percent compared to a year ago. **(Figure 8)**

The surging cost of fuel over the past few months has caused the consumer-price index (CPI) to rise. In August, the CPI shot up 0.6 percent, the biggest increase since June 2009. The core index, which excludes food and fuel, climbed 0.1 percent. On a yearly basis, CPI is up 1.7 percent, while core CPI is up 1.9 percent. Overall, the benign inflation pressure has allowed the Fed to more actively pursue its full employment mandate. **(Figure 9)**

In September, the Fed announced a third round of quantitative easing and said that it would purchase $40 billion a month in mortgage-backed securities for as long as it takes to achieve a meaningful drop in unemployment. The purpose of the program is to push down long-term interest rates in order to encourage people to take more risk. By the Fed buying bonds and mortgage-backed securities, prices of bonds increase, and yield falls, which makes their return less attractive and encourages investors to move money into corporate bonds and equities. Lower long-term bond rates are also meant to motivate consumers to purchase homes. Since the third round of easing was announced, rates have indeed fallen – the ten-year rate has dropped from 1.87 on September 14th to around 1.70 today; however, it's difficult to attribute whether the drop is due to the Fed's policy or because global markets have pulled back. **(Figure 10)**

As we begin the fourth quarter 2012, opinion on the direction of the economy has become even more polarized, with bulls pointing to the improvement in jobs, housing, and consumer spending, and bears pointing to the recession in Europe, slowdown in China, and the looming fiscal cliff. The economy has faced these three pressures all year, yet economic data is improving despite these headwinds. Time will tell whether the recent pickup in economic activity in the U.S. is just a bounce or if it will be sustained. There is one thing that is certain; corporations continue to have strong balance sheets with huge amounts of cash. Once some of the uncertainty is cleared, and this cash is put to work, the economy should return to healthy levels of growth.

Figure 1

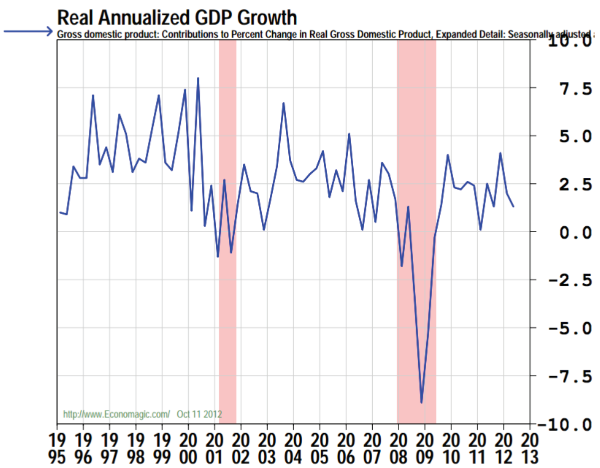


Figure 2

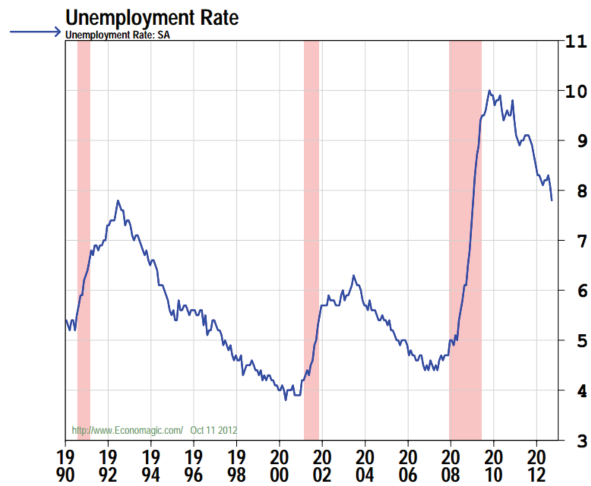


Figure 3

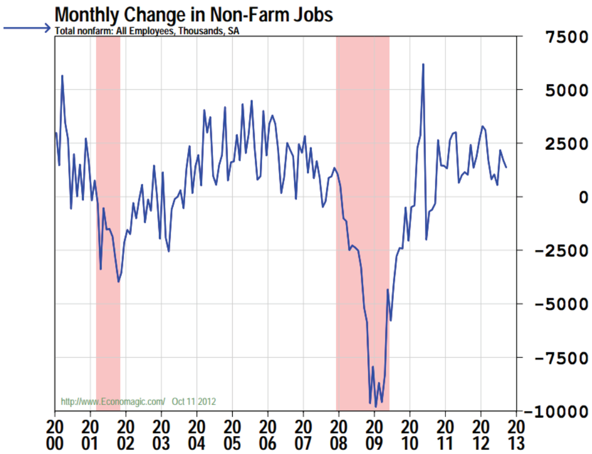


Figure 4

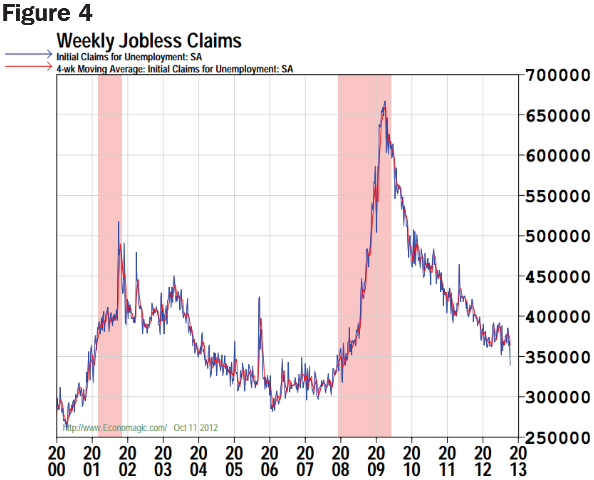


Figure 5

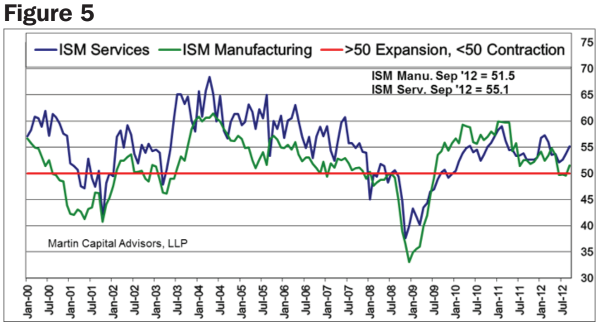


Figure 6

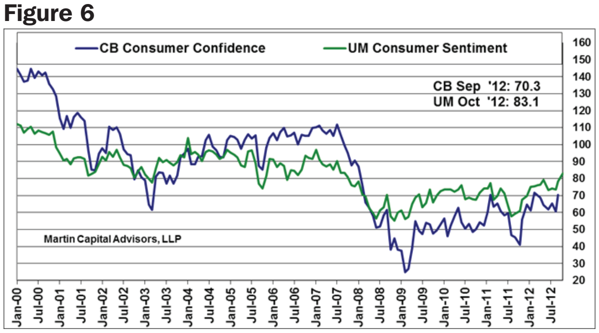


Figure 7

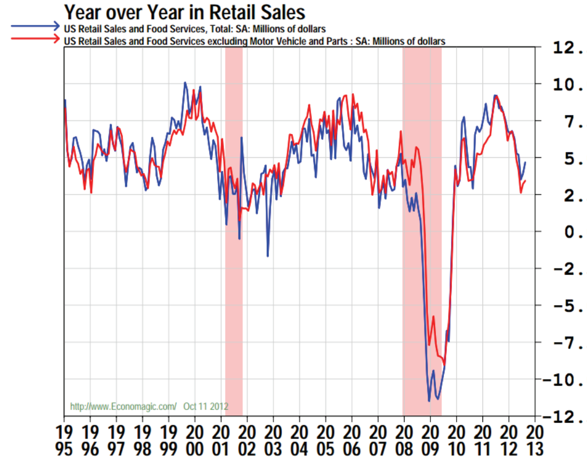


Figure 8

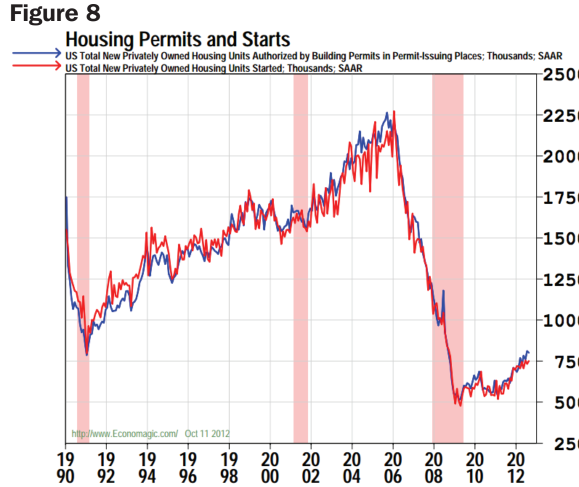


Figure 9

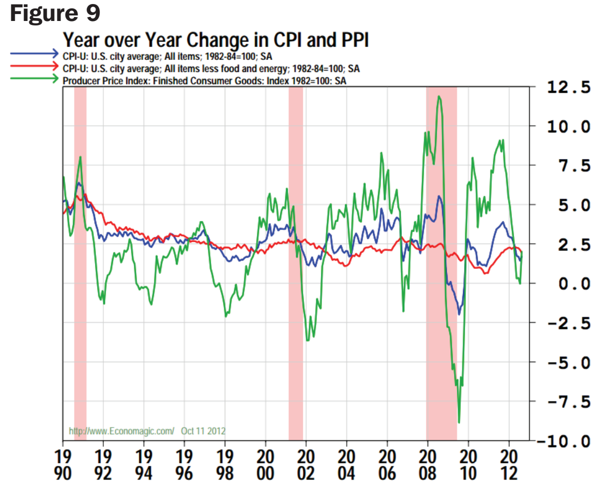
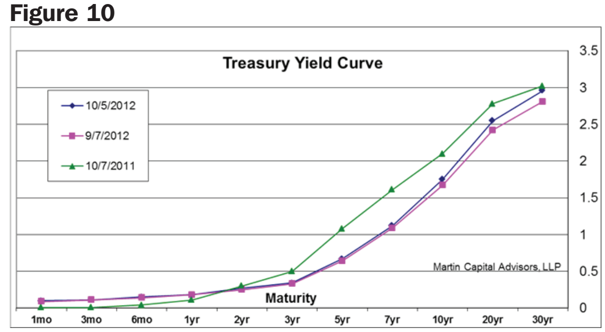


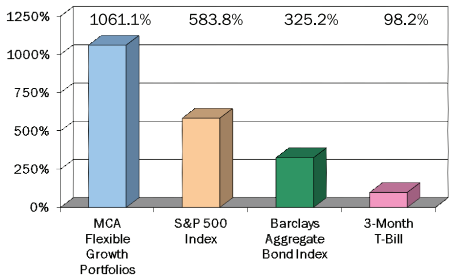
Figure 10



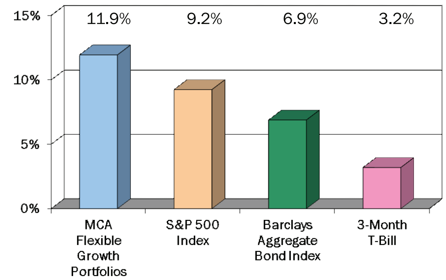
RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to September 30, 2012

Total Return



Annualized Return



THE COMPASS

A Quarterly Publication of
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 CGM Investment Management.

MCA FLEXIBLE PORTFOLIOS TOP 20 POSITIONS

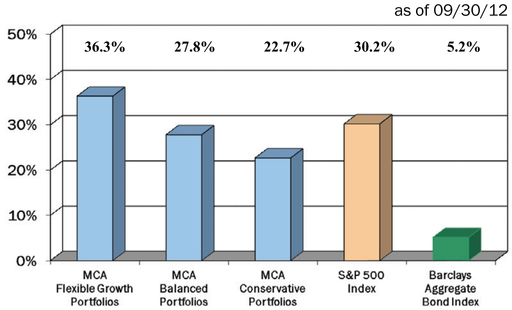
as of September 30, 2012

1	Apple	667.105	6	Oracle	31.46	11	Caterpillar	86.04	16	Intel	22.655
2	Whole Foods Market	97.40	7	Williams-Sonoma	43.97	12	Texas Instruments	27.555	17	Mastercard	451.48
3	Starbucks	50.71	8	Davita	103.61	13	SanDisk	43.43	18	OmniVision Technologies	13.96
4	NASDAQ 100 ETF	68.57	9	Tiffany	61.88	14	Cisco Systems	19.095	19	Costco Wholesale	100.16
5	Intuitive Surgical	495.63	10	NASDAQ Biotech Index	142.59	15	Charles Schwab	12.785	20	Coach	56.02

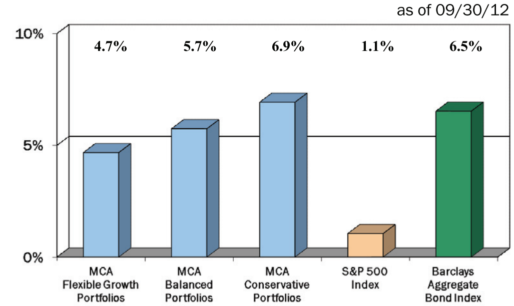
INVESTMENT RESULTS

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

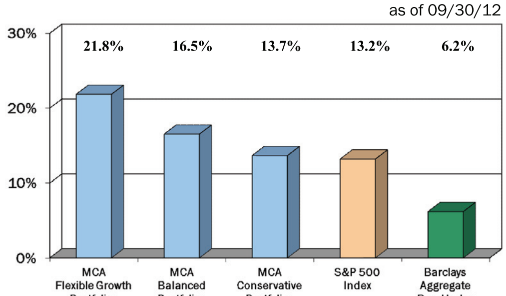
One-Year
Returns
as of 09/30/12



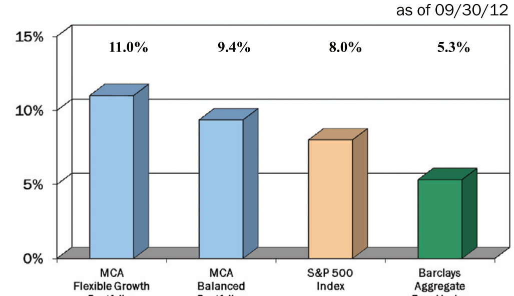
Five-Year
Annualized Returns
as of 09/30/12



Three-Year
Annualized Returns
as of 09/30/12



Ten-Year
Annualized Returns
as of 09/30/12



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 9/30/2012, the *MCA Flexible/Balanced/Conservative/Enhanced ETF Portfolios* returns represent, respectively, 29/4/2/3 individual portfolios and 67%/28%/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 Portfolio*s 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.