THE COMPASS

January 2013

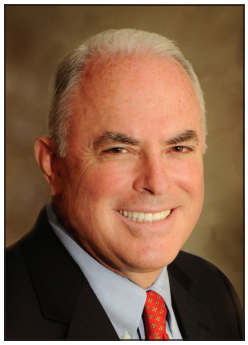
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

2012 Turned Out to be a Very Good Year, Despite a Myriad of Issues and Concerns

January 23, 2013

In 2012 stocks climbed the proverbial "wall of worry" to solid gains for the year, with the S&P 500 returning 16.0% and the MCA Flexible Growth Portfolios averaging 18.7%. Essentially, strong corporate balance sheets and low valuations were able to counter-balance sluggish economic growth, flagging corporate profits, and fiscal and monetary problems around the world.



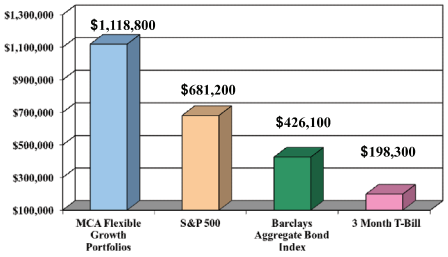
The performance of fixed income securities was moderate for 2012, with the Barclays Aggregate Bond Index returning 4.2%. Although bonds continued to be tremendously overvalued, ongoing economic uncertainty and QE3 purchases by the Fed helped keep rates low.

As we enter 2013, both stocks and bonds have gotten off to a good start. The same forces at play in 2012 have carried over into 2013. Whether these forces persist for the rest of the year remains to be seen, but my best guess is that 2013 will be another good year for stocks; however, this may be the year that the bond bubble begins to burst. The catalyst for lower bond prices probably will be an improvement in economic activity later in the year, which of course would be a positive catalyst for stocks.

Extremely accommodative monetary policies around the world are slowly but surely bringing the U.S. and global economies back to more normal operating conditions. This can best be seen in the U.S. housing market, in which a robust recovery is now underway after many years of being a drag on the economy. Although high government debt and deficits will continue to be an issue for the economy for many years, very high cash levels held by investors and corporations will eventually be put to work and should more than compensate for deficit reducing budget cuts in government spending.

Interestingly, the inevitable bursting of the bond bubble will be the best sign that the economy is well down the road to a full recovery from the Great Recession. Interest rates today are near all-time lows, but as economic growth gains momentum, interest rates will rise in anticipation of higher inflation. When investors who overwhelmingly have sought refuge from the stock market in the apparent safety of bonds begin to realize that their bond portfolios are losing money as interest rates rise, the mass exodus will further drive up interest rates and the bond bubble will burst. The stock market, however, with the exception of interest rate sensitive stocks, such as utilities and high dividend payers, most likely will shrug off the rise in rates and benefit, at least initially, from the stronger economic growth that will be the primary catalyst for the bursting of the bond bubble. Accordingly, investment portfolio allocations should be underweighted in bonds and overweighted in stocks for the foreseeable future.

Growth of $100K
1/1/91–12/31/12



See details and important Disclosure Notice on last page.

COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to December 30, 2012

	Martin Capital Advisors[1]	S&P 500	Wilshire 5000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
Total[2]	1018.8%	581.2%	629.1%	326.1%	98.3%	72.1%
Avg.[3]	11.6%	9.1%	9.5%	6.8%	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. ——

In the third quarter the economy grew 3.1 percent, this was a significant bounce from the 1.3 percent growth rate recorded in the second quarter, but the acceleration was largely attributed to a build up of inventories. Growth for the fourth quarter is currently tracking at 2 percent, as businesses have slowed down production to sell off excess inventories. The projected slowdown in growth is not as severe as was once expected – preliminary GDP readings for the fourth quarter were first around 1 percent and have steadily ticked upwards. This is because business capital spending, which was very soft in the third quarter, has bounced back with new orders for capital goods moving higher. (Figure 1)

The employment report for December, which many had feared would be negatively impacted by the Fiscal Cliff, continued to show steady gains. The economy added 155,000 jobs in December, led by a 168,000 increase in private sector jobs, but dragged down by the government shedding 13,000 jobs. The number of jobs added in December was in line with the monthly average for both 2011 and 2012, confirming a slow and sustained recovery in the job market. The unemployment rate remained at 7.8 percent, near its four year low. Another good sign from December's employment report was that employees are working longer hours and receiving higher compensation. Average earnings were 0.3 percent higher and are 2.1 percent higher compared to a year ago. Personal incomes rose 0.6 percent in November and are 4.1 percent higher compared to year ago. (Figure 2)

Rising incomes combined with the current low inflationary environment should bode well for consumer spending and contribute positively to GDP in 2013. Consumer spending accelerated in the later half of 2012, reaching a four-year high in August. Spending declined in October due to Hurricane Sandy and concerns over the Fiscal Cliff, but has since rebounded 0.4 percent. Though holiday sales appear to have been weaker than expected, overall retail sales are steadily increasing and are up 3.7 percent year over year. Autos sales had their best year since 2007, recording 15.3 million units in December and up 13.7 percent compared to a year ago. The fiscal mess in Washington appears to have caused consumer sentiment to weaken, and since the problem remains largely unresolved, there is a risk that weak sentiment could dampen future consumer spending.

After bottoming a year ago, the housing market continues to rebound aggressively. Pending sales of existing homes are up 9.8 percent compared to a year ago, and the growth from last month was the highest recorded since April 2010 – a time when the housing market was still being boosted by the home-buyer tax credit. The strong sales rate has drawn down the supply of housing in the market to 4.8 months, which is below the long-term average of 6 months. Home construction is booming – housing starts jumped 22 percent in the second half of 2012. Housing will likely continue to be strong in 2013. The report on building permits for homes, which provides an indication of future construction, rose 3.6 percent in November to the highest level since July 2008. (Figure 3)

At the end of last quarter, the cost of fuel had surged, causing the consumer-price index (CPI) to rise. Since then fuel costs have subsided with the average price of fuel dropping 58 cents per gallon. The decline in fuel prices was one factor that contributed to an overall drop of 0.3 percent in the CPI for November. On a yearly basis, the CPI is up 1.8 percent, which is well below the long-term rate of 3.0 percent.

Treasury rates have risen lately with the 10-year note near eight-month highs. The cause for the jump was growing concern that the Federal Reserve may end the third round of debt purchasing that they announced in September, earlier than investors expected, due to a growing consensus of a better growth outlook. Improving economic conditions should cause yields on the long-end of the yield curve to continue to increase and the overall yield curve to steepen as short-term rates are expected to stay near zero for the next few years. (Figure 4)

While many economic indicators continue to move in a positive direction and the global economy appears to be on much stronger footing than it was a year ago, the U.S. is still currently in a low growth environment with GDP tracking around 2 percent. If Congress can reach a fiscal resolution that provides certainty to businesses and doesn't aggressively raise taxes or cut spending in the near-term, then our economy will likely experience higher levels of growth in 2013.

ECONOMIC CHARTS

as of 12/31/2012

Figure 1

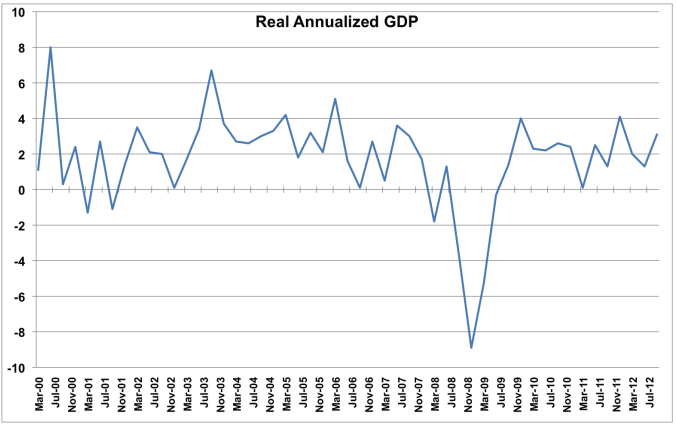


Figure 3

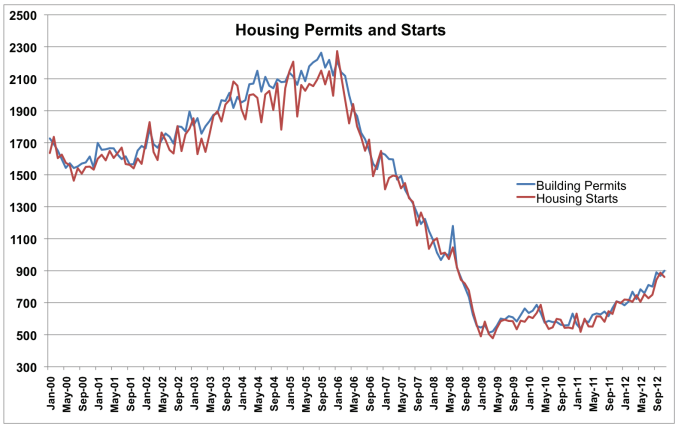
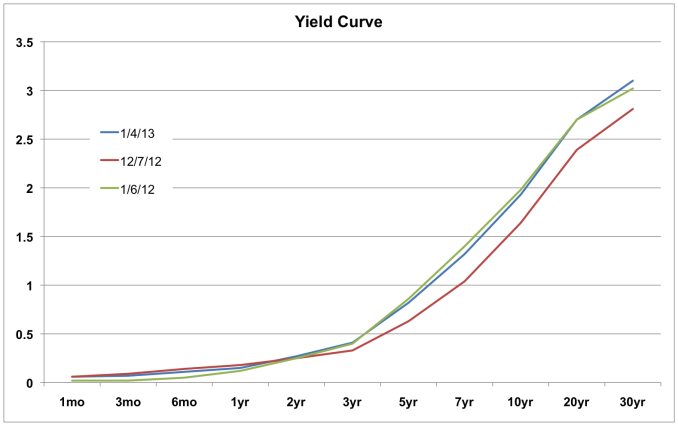


Figure 2

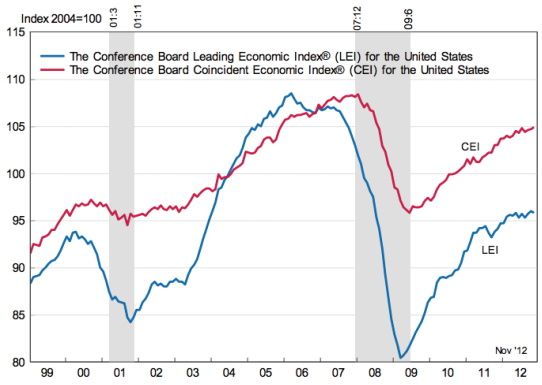
Figure 4



LEADING ECONOMIC INDICATORS

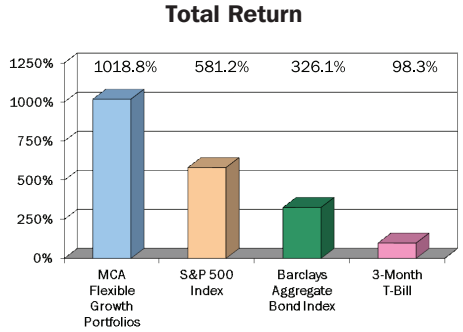
as of 12/31/2012

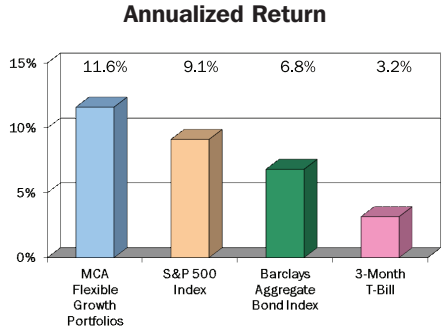
	Current Reading	1-month change	6-month change
Conference Board Leading Economic Index	95.8	-0.2	0.0
S&P 500 Index	1426	0.71%	4.7%
Average weekly hours, manufacturing	40.7	0.1	0.1
Initial Jobless Claims	367K	-45K	-26K
Manufacturers' new orders for consumer goods	35.70B	2.9%	-0.8%
Manufacturers' new orders for nondefense capital goods	70.67B	2.6%	-3.0%
ISM New Orders Index	50.3	0.0	2.5
Building permits	900K	3.7%	14.8%
Spread between 10-yr Treasury Note and Federal Funds Rate	1.69	0.23	0.11
Expectations from UM Consumer Sentiment Index	63.8	-13.8	-4.0
Money Supply	10.4T	1.6%	5%



RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to December 31, 2012





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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.

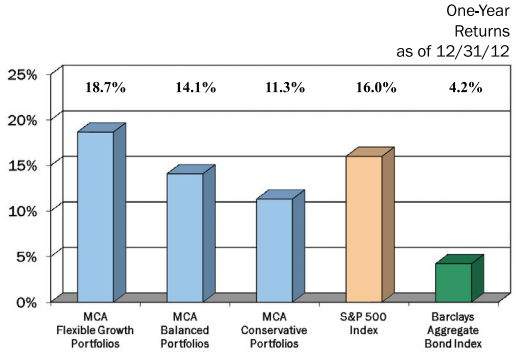
MCA FLEXIBLE PORTFOLIO TOP 20 STOCKS

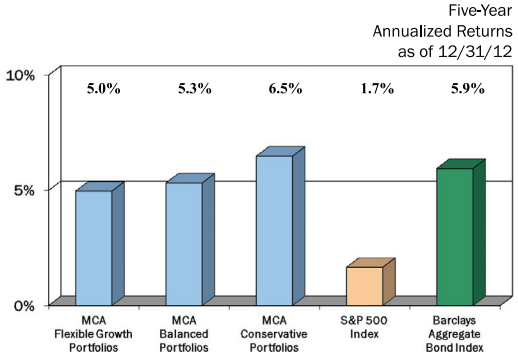
as of December 31, 2012

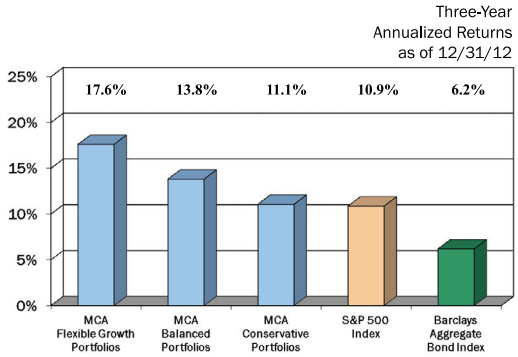
1	Apple	532.17	6	DaVita	110.53	11	Charles Schwab	14.36	16	OmniVision	14.08
2	Whole Foods Market	91.16	7	Williams-Sonoma	43.77	12	SanDisk	43.50	17	Costco	98.73
3	Starbucks	53.63	8	Texas Instruments	30.89	13	Cisco Systems	19.65	18	Coach	55.51
4	Intuitive Surgical	490.37	9	Tiffany	57.34	14	Mastercard	491.28	19	Visa	151.58
5	Oracle	33.32	10	Caterpillar	89.61	15	Intel	20.62	20	Blackrock	206.71

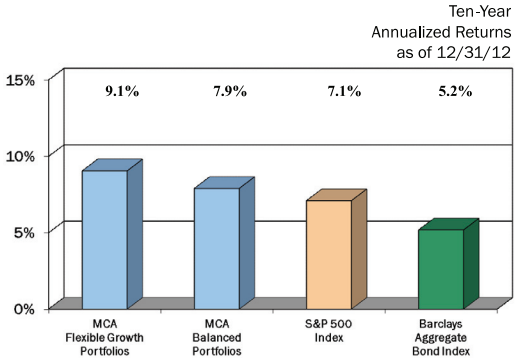
INVESTMENT RESULTS

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









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 12/31/2012, the *MCA Flexible Growth/Balanced/Conservative* returns represent, respectively, 31/5/2 individual portfolios and 66%/29%/4% of all funds under management by MCA. Clients explicitly elect these management styles on their Personal Data Form. The *MCA Flexible Growth* 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.