THE COMPASS

April 2013

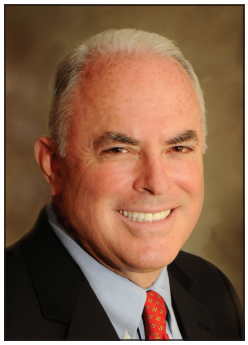
A Quarterly Newsletter of Martin Capital Advisors, LLP

## INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

# Strong 2012 stock market performance carries into 2013

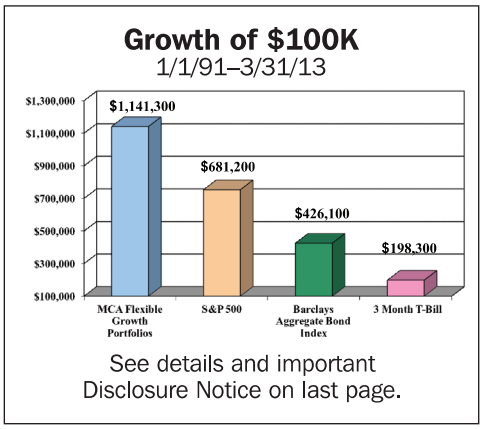
*April 15, 2013*

Major stock market indices built on 2012 gains in the first quarter of 2013 as improving economic activity trumped concerns about government spending and legislative uncertainty regarding the deficit. Martin Capital returns, however, were only slightly positive due to weakness in some of the stocks that have been strong contributors to the outperformance of the portfolios over the last few years, such as Apple, which was down almost 17% for the quarter. Fixed income returns were mixed, with the Barclays Aggregate Bond Index spending most of the quarter in negative territory, but managing to finish flat in response to some signs that economic strength could be waning at the end of the quarter.



Economic data at the beginning of the second quarter is continuing to show signs of a slowdown from the respectable pace seen in most of the first quarter. In particular, the weaker than expected employment report for March is causing many economists to ratchet down their second quarter forecasts. Although it's not possible to say at this point whether the recent weakness seen in some economic indicators will persist, it is likely that second quarter growth will be slower than the approximately 3% GDP growth currently estimated for the first quarter.

Over the next few months market analysts and investors may be making recommendations and investment decisions based on the potential for another slowdown in economic growth and its potential impact on corporate earnings, so there is an above average chance that the second quarter will give back at least some of the gains of the first quarter. However, as I've mentioned in previous newsletters over the past few years, the problem with selling into any near-term pullback in the stock market is getting back in before prices recover again to new highs. One of the hallmark characteristics of bull markets is that most investors are preoccupied with avoiding corrections all of the way up and consequently miss a lot of the stock market gains. While short-term changes in economic strength and weakness often have an effect on the financial markets, it's important to stay focused on longer-term trends, which remain quite positive due to accommodative central bank policies, low valuations, low interest rates, the rebounding housing market and strong corporate balance sheets. On the negative side, legislative uncertainty regarding the sequester and the deficit, along with periodic global instability, will continue to be catalysts for corrections from time to time, but investors should not miss the forest for the trees by reacting to short-term negative factors at the expense of losing sight of the positive factors that should keep the bull market on course for the long run.




See details and important Disclosure Notice on last page.

## COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to March 31, 2013

| | Martin Capital Advisors[1] | S&P 500 | Wilshire 5000 | Barclays Aggregate Bond Index | 3 Month T-Bill | Consumer Price Index |
|---|---|---|---|---|---|---|
| Total[2] | 1041.3% | 653.5% | 711.0% | 325.6% | 98.3% | 73.5% |
| Avg.[3] | 11.6% | 9.5% | 9.9% | 6.7% | 3.1% | 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]1991-2013 annualized return.

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

During the fourth quarter of 2012 the economy grew at a tepid rate of 0.4 percent. The main cause for the slump was a draw down in inventories, as businesses anticipated a potential reduction in demand caused by cuts in government spending and increases in taxes. As we entered the New Year, fiscal headwinds along with rising gas prices, slowing job growth, and weakening consumer spending, had many economists believing that growth in the first half of 2013 would continue to be lackluster. However, the perception began to quickly change after a series of strong reports for labor, housing, and a string of other economic data showed a marked pickup in economic activity. This caused economists across the board to revise their first quarter GDP projections to the 2.5 to 3.5 percent range after initially projecting growth to be below 2 percent. (Figure 1)

The primary driver for the upward revision in GDP and optimism in the U.S. economy had been a series of better than expected labor reports. Prior to the disappointing jobs report in March, in which only 88,000 jobs were added, the economy had recorded 5 consecutive months of private sector payroll gains that averaged over 200,000 jobs per month. This helped bring down the unemployment rate to 7.6 percent. Until the weak jobs report in March, some economists and investors had been calling for the Fed to end its asset-purchasing program; however, the Fed has indicated that they are committed to continuing to pump liquidity into the market, and the low jobs number in March confirms that the Fed's asset-purchasing program continues to be justified. (Figure 2)

The economic improvements since the beginning of the year have yet to positively affect consumer's economic expectations. In March, Consumer Confidence plummeted 8.3 points to 59.7, but the Consumer Sentiment Index came in at 78.6, one point higher than February's reading. While consumers may have mixed feelings about the economy, consumer spending continues to be strong, despite the 2 percent increase in payroll taxes and the $85 billion in government spending cuts passed by Congress. In February, retail sales were up 1.1 percent, which was well above expectations, and January's figure was revised up 0.2 percent. Auto sales also have been strong and recorded their best month in March since December 2007.

The housing market is normally a leading driver of economic recovery, but until last year housing continued to be a drag. Finally, in 2012, the housing market turned, and now its upward momentum is fueling the economy. In February housing starts rose 0.8 percent and are up 27.7 percent in a year. Building permits were up 4.6 percent and continue to be higher than starts, indicating future construction will be strong. Not only is the market for new homes healthy, but also the market for existing homes is improving, with sales rising 0.8 percent in February and up 10.2 percent in the last year. All of the activity in the housing market has caused home prices to rise 11.6 percent in the last year, but there is still a lot of room for growth after the 35 percent decline from 2006 to 2012. (Figure 3)

While an end to some of the Fed's asset-purchasing programs might be coming sooner than many initially expected, the Fed is not expected to change the target federal funds rate of 0 to 0.25 percent for at least the next year. The reason being: inflation remains low with the both CPI and core CPI up 2.0 percent in the last year. While economic data in the U.S. continued to be positive over the quarter, commodity prices fell, reflecting the weakness in other economies and headwinds from the government sequester. Gasoline prices dropped 15 cents March, and commodity prices have fallen across the board.

The Fed's commitment to keeping short-term rates low combined with an improving economy has caused the yield curve to steepen over the quarter as long-term rates have began to inch up. Investors are slowly beginning to demand a higher return for long-term Treasuries, however from a historical perspective, Treasury rates are still near all-time lows. These low long-term rates are contributing to the revival in the housing and auto markets. (Figure 4)

After a strong start to the first quarter, recent economic data, such as the latest employment report, have started to show some signs that economic growth may be softening again. Whether this is a short-term aberration or a return to the anemic economic growth experienced in the fourth quarter of last year remains to be seen, but the most likely scenario is that the economy will continue to vacillate between periods of subpar and moderate growth for the foreseeable future.

## ECONOMIC CHARTS

as of March 31, 2013

**Figure 1**

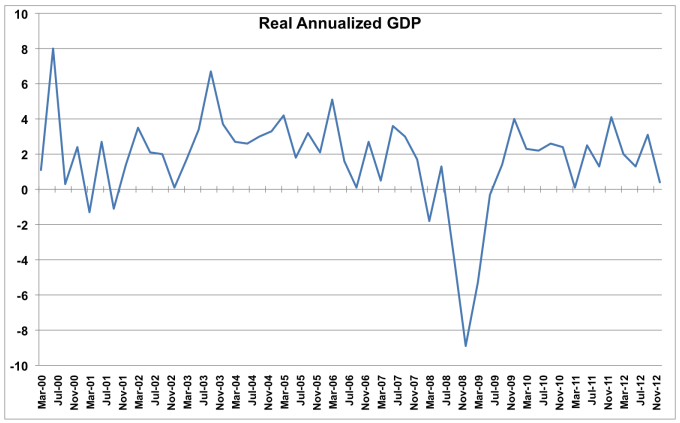



**Figure 3**

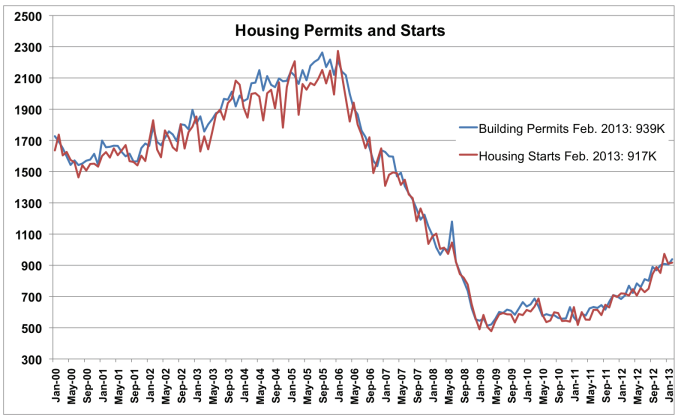



**Figure 2**

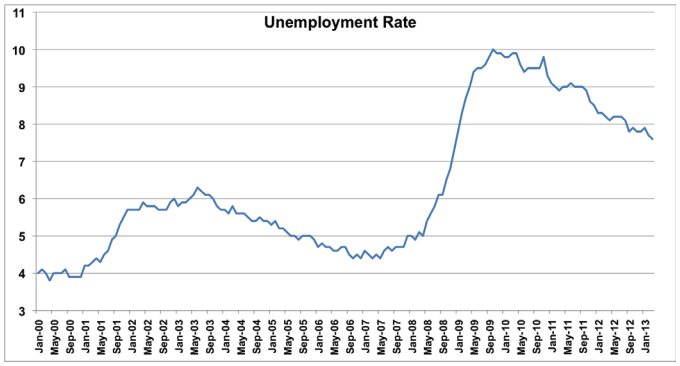
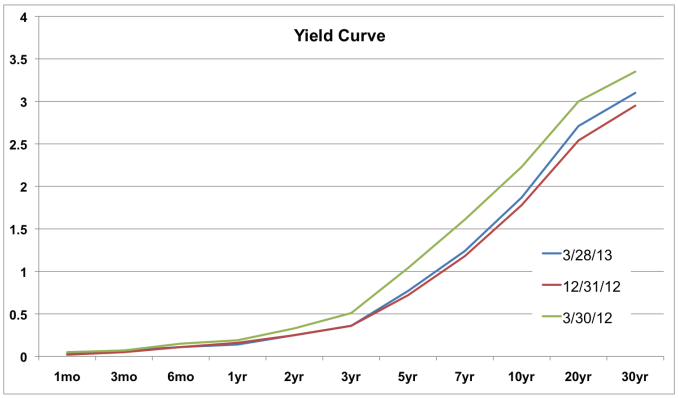


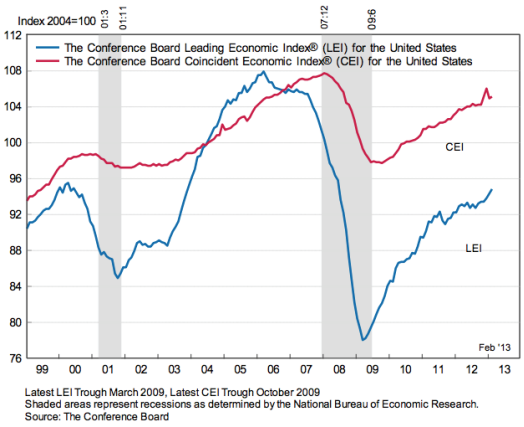

**Figure 4**




## LEADING ECONOMIC INDICATORS

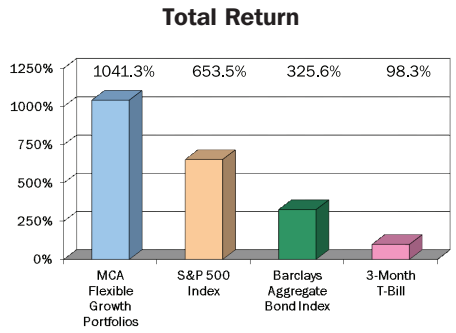
as of March 21, 2013

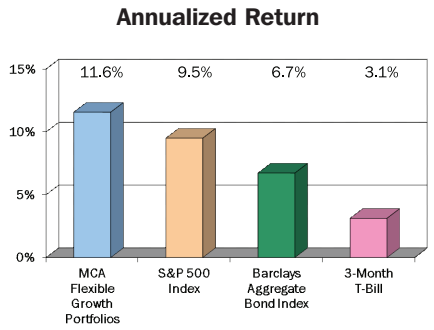
| | Current Reading | 1-month change | 6-month change |
|---|---|---|---|
| Conference Board Leading Economic Index | 94.8 | 0.5% | 2.3% |
| S&P 500 | 1512 | 2.2% | 7.8% |
| Average weekly hours, manufacturing | 41.9 | 0.2 | 0.3 |
| Initial Jobless Claims | 349.2K | -2K | -22.6K |
| Manufacturers' new orders, capital goods ex. aircraft | 40.4B | -2.6% | 9.5% |
| Manufacturers' new orders, consumer goods and materials | 129.9B | 0.1% | 1.2% |
| ISM New Orders | 57.8 | 4.5 | 8.9 |
| Building Permits | 946K | 4.6% | 18.1% |
| Spread between 10-yr Treasury Note and Federal Funds Rate | 1.83 | 0.06 | 0.28 |
| Avg. Consumer Expectations for Business Conditions | -0.54 | 0.43 | 0.41 |
| Leading Credit Index (negative readings are positive for the LEI) | -1.63 | 0.42 | -0.7 |



## RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to March 31, 2013





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A Quarterly Publication of
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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.

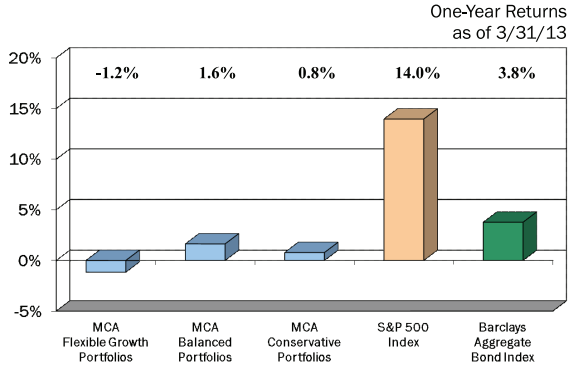
## MCA FLEXIBLE PORTFOLIO TOP 20 STOCKS

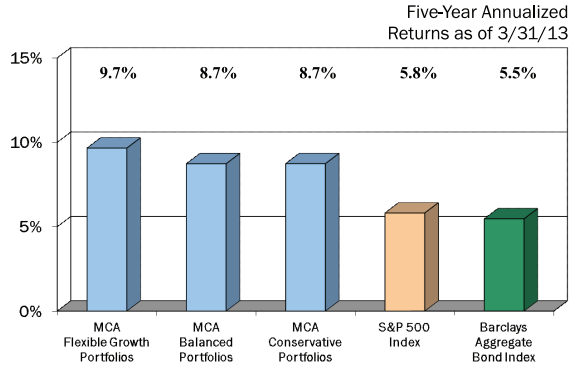
as of March 31, 2013

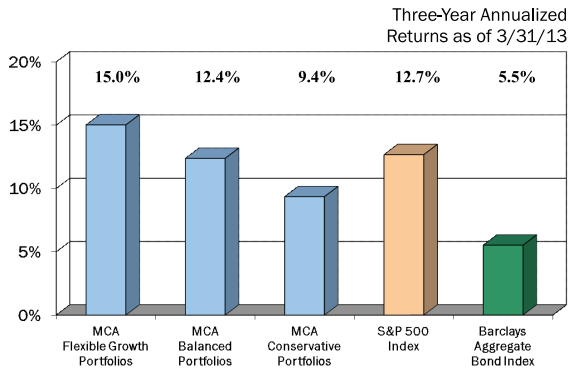
| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Apple | 442.66 | 6 | Williams-Sonoma | 51.52 | 11 | Charles Schwab | 17.69 | 16 | Intel | 21.84 |
| 2 | Whole Foods Market | 86.75 | 7 | DaVita | 118.59 | 12 | Mastercard | 541.13 | 17 | Costco | 106.11 |
| 3 | Starbucks | 56.95 | 8 | Tiffany | 69.54 | 13 | Cisco Systems | 20.90 | 18 | OmniVision | 13.77 |
| 4 | Intuitive Surgical | 491.19 | 9 | Texas Instruments | 35.48 | 14 | Caterpillar | 86.97 | 19 | Blackrock | 256.88 |
| 5 | Oracle | 32.33 | 10 | SanDisk | 54.96 | 15 | Ebay | 54.22 | 20 | Visa | 169.84 |

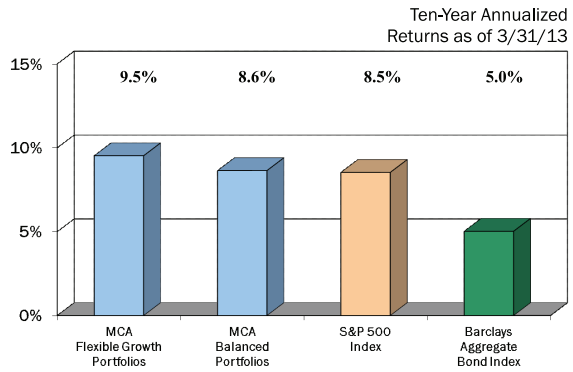
## INVESTMENT RESULTS

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 3/31/2013, the *MCA Flexible Growth/Balanced/Conservative* returns represent, respectively, 30/6/2 individual portfolios and 65%/30%/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.