THE COMPASS

July 2013

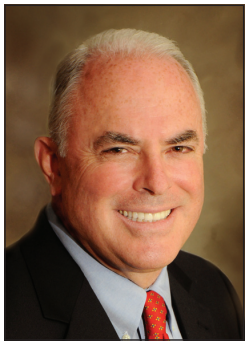
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Stocks Climb as Bonds Fall, Gold Plunges

July 18, 2013

Stocks climbed higher in the second quarter, with stock indexes improving on double digit first quarter gains. For example, the S&P 500 advanced 2.9% in the last three months to achieve a total year-to-date return of 13.8%. Although Martin Capital returns were better than most broad stock market indexes during the second quarter, advancing almost 4.6% for the MCA Flexible Growth Portfolios, one-year and year-to-date returns continued to lag the S&P 500. Longer-term returns for Martin Capital, however, remain well ahead of the S&P 500 benchmark, as shown below and in charts on the last page. Bond prices fell in the second quarter, adding to first quarter losses, resulting in a year-to-date total return for the Barclays Aggregate Bond Index of -2.3%. Interestingly, signs of a somewhat weakening economy in the second quarter should have weighed on equity prices and buoyed bond returns, but the opposite happened, perhaps in large part due to the extreme over-valuation of bonds and the under-valuation of stocks, as well as the financial markets beginning to anticipate stronger economic growth later this year.

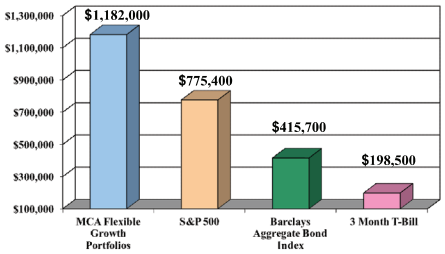


As the third quarter begins, stocks are building on their gains from the first half of the year, while bond returns are flat. At this point, the risk of a stock market correction has risen somewhat, but the long-term prospects remain bullish. My forecast for bonds is the opposite of stocks, with some chance of a short-term rally, but long-term prospects seem quite bearish. I have given my reasons for these positions in previous newsletters that can be found on our website, www.martincapital.com, so now I'd like to talk about gold, since I know that many investors in gold are wondering what to do these days.

Gold prices plunged in the second quarter and they are now nine months into what could be a multi-year bear market. The problem with gold is that it doesn't have earnings, doesn't pay dividends or interest, and doesn't get depleted or made rarer (almost all the gold that has ever been mined still exists today). The price of gold is driven mostly by human emotion and sentiment, which has swung wildly over the years, but the net effect is that the inflation-adjusted return for gold over long periods of time is not much above zero. This is demonstrated by the fact that going back generation after generation for hundreds of years a man could buy a new suit with an ounce of gold, albeit sometimes a very nice suit, but never a new house. In my opinion, there have been a couple of primary drivers for the run-up in the price of gold from 2001 to 2011. The first is that gold was in high demand as a hedge against the uncertainty caused by multiple wars and economic disruptions. The second is that it became much easier to buy gold with the introduction of exchange traded funds (ETFs) that hold gold for their investors, such as SPDR Gold Shares, symbol GLD.

Although high uncertainty could return at any time and benefit the price of gold, too many investors, as demonstrated by the large increase in the price of gold from 2001 to 2011, have gone from using gold as an investment portfolio hedge to making major bets on it rising forever. Unfortunately for gold investors, the gold ETFs that facilitated the rise in gold into 2011 also can facilitate the selling of gold, which has been happening for the last 18 months. My guess, based on historical cycles, is that gold could mount a counter-trend rally at some point in the near future, but that it probably will break well below $1,000.00 per ounce within the next few years, so any speculative positions in gold that remain in an investment portfolio should be reduced to minimum diversification targets.

Growth of $100K
1/1/91–6/30/13



See details and important Disclosure Notice on last page.

COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to June 30, 2013

	Martin Capital Advisors[1]	S&P 500	Wilshire 5000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
Total[2]	1082.0%	675.4%	734.5%	315.7%	98.5%	74.1%
Avg.[3]	11.6%	9.5%	9.9%	6.5%	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. ——

The final GDP report for the first quarter of 2013 came in at an annualized rate of 1.8 percent, much weaker than initial estimates, which had forecasted economic growth to be above 3 percent. The economy now has recorded two consecutive quarters of growth below 2 percent, and estimates for the second quarter are not showing any signs of improvement, with GDP currently tracking around 1 percent. (Figure 1)

Tepid GDP growth, however, might be exaggerating the weakness of the U.S. economy – one reason GDP has been so sluggish is due to a widening trade deficit caused by a troubled global economy. As other economies continue to teeter in recessionary territory, the dollar has strengthened, and this has caused U.S. exports to be less competitive and imports to be cheap, which is widening the trade deficit and weakening GDP. So while GDP growth is slow, the fact that U.S. consumers and businesses are at least purchasing goods, albeit goods from foreign countries, is a positive indicator.

In June the economy added 195,000 jobs, which was nearly 30,000 jobs above consensus, and big upward revisions for April and May added 70,000 jobs to what was previously reported. In the last three months, the economy has averaged job growth close to 200,000 jobs per month, but the unemployment rate has remained around 7.6 percent. As the labor market continues to improve, concerns that the Federal Reserve may begin to taper its bond buying program has caused long-term interest rates to rise sharply. (Figure 2)

While the Fed likely will begin to taper bond purchases soon, there is strong reason to doubt that the Fed will begin to raise the Fed Funds rate anytime soon. The Fed uses interest rates to control inflation, and in the last year inflation is only up 1.4 percent, which is below the Fed's target of 2 percent. At this point, the Fed is still more worried about deflation than inflation, so they will not raise rates if inflationary pressures continue to be weak.

The bond market is already beginning to anticipate the end of quantitative easing. Over the quarter, the 10-yr treasury rose from a low of 1.66 basis points to as high as 2.60 basis points. This was one of the sharpest increases in history. Meanwhile, short-term rates remain low, so the jump in long-term rates has caused the yield curve to steepen, which is a positive indicator for the economy and stocks. (Figure 3)

The hike in long-term rates is unlikely to spook the housing market, as overall rates are still very low. Rather than hurting housing and auto markets, the increase in rates might provide an impetus for consumers to act. Housing continues to be a strong tailwind for the economy with housing permits and starts for new homes up 22.2 percent and 28.6 percent in the last year, respectively. The market for existing homes is also improving with prices in metropolitan areas up 12.1 percent and sales up 12.9 percent in the last year. (Figure 4)

The increase in home and stock prices helps Americans feel wealthier. The wealth effect along with an improving labor market, and rising wages, coupled with low inflation, has improved consumer sentiment and helped American's shake off higher taxes and the spending cuts mandated by sequestration. The UM Sentiment Index was 84.1 points in June, down slightly from the six year high it set in May, and Consumer Confidence was 81.4 in June, up from 74.3 points in May. Rising sentiment has contributed to steady growth in retail sales, which are up 4.3 percent in the last year. Auto sales continue to be strong and are on track for the best year since 2007.

While the world economy remains weak and the U.S. economy seems to be stuck in neutral, there is reason to be optimistic that growth will pick up in the second half of this year. Consumers are leading the recovery, and this momentum is likely to build, as inflation remains low, the housing market strong, and the labor market is steadily improving. Furthermore, there has been a pick-up in business spending as new orders for nondefense capital goods, excluding aircraft, have increased for three straight months for the first time since 2011. The economy faces headwinds from cuts in government spending, weak global demand, and volatility surrounding the actions of the Fed, but as long as the consumer remains resilient and business spending continues to improve, then growth should accelerate.

ECONOMIC CHARTS

as of June 30, 2013

Figure 1

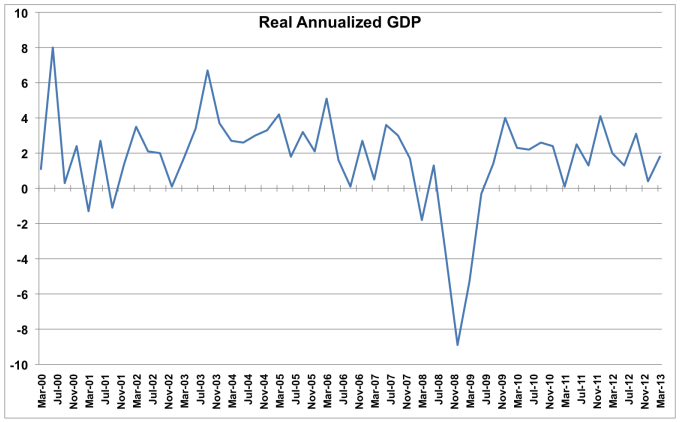


Figure 2

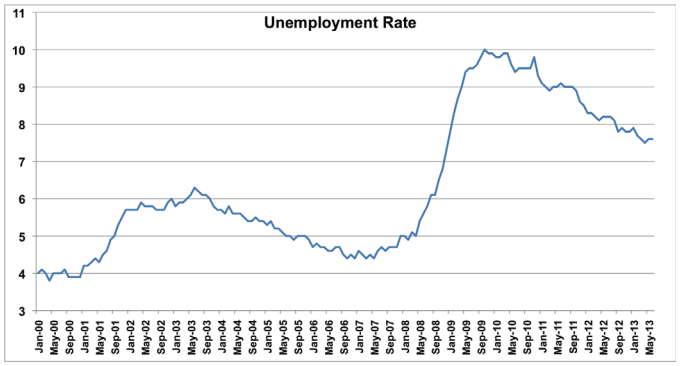


Figure 3

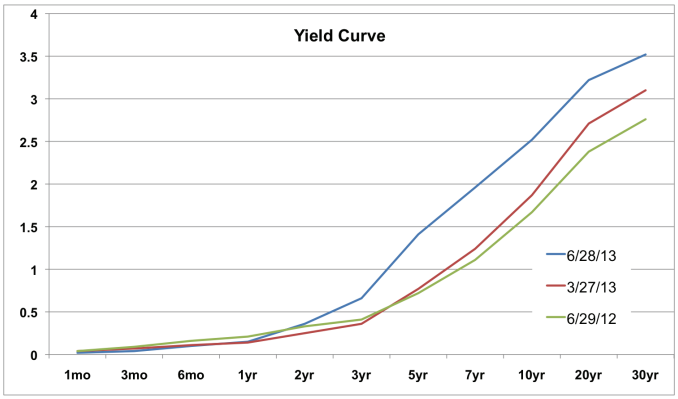
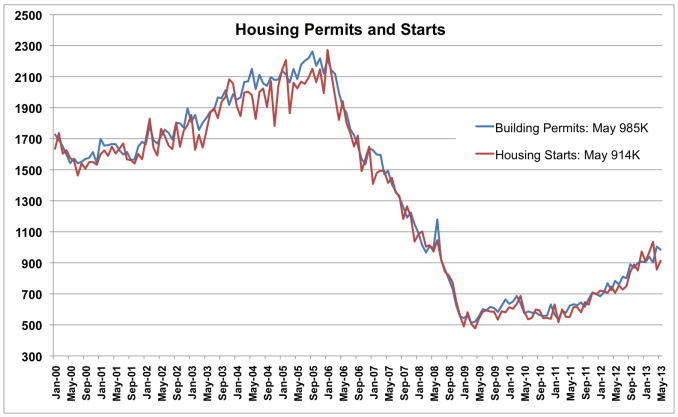


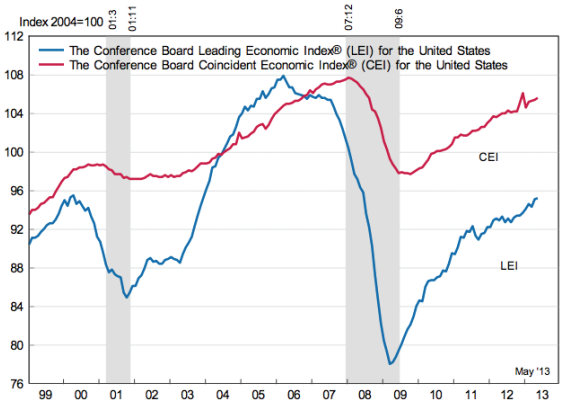
Figure 4



LEADING ECONOMIC INDICATORS

as of June 20, 2013

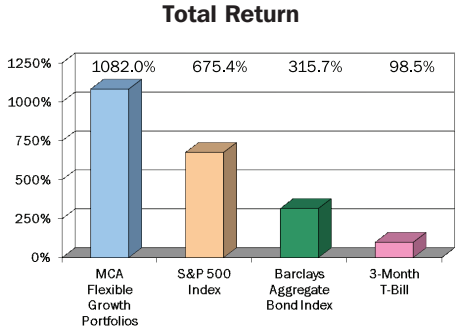
	Current Reading	1-month change	6-month change
Conference Board Leading Economic Index	95.2	0.1%	1.9%
S&P 500	1639	4.4%	17.6%
Average weekly hours, manufacturing	41.8	0.0	0.2
Initial Jobless Claims	352K	10K	-50K
Manufacturers' new orders, capital goods ex. aircraft	40.9B	-0.3%	3.3%
Manufacturers' new orders, consumer goods and materials	129.2B	0.0%	-0.7%
ISM New Orders	48.8	-3.5	-2.3
Building Permits	974K	-3.1%	4.4%
Spread between 10-yr Treasury Note and Federal Funds Rate	1.82	0.21	0.33
Avg. Consumer Expectations for Business Conditions	-0.2	0.52	0.20
Leading Credit Index (negative readings are positive for the LEI)	-1.74	-0.55	-0.75

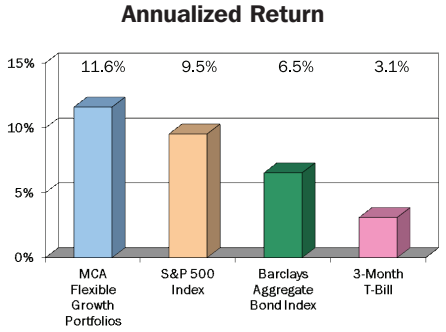


Latest LEI Trough March 2009, Latest CEI Trough October 2009
Shaded areas represent recessions as determined by the National Bureau of Economic Research.
Source: The Conference Board

RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to June 30, 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.

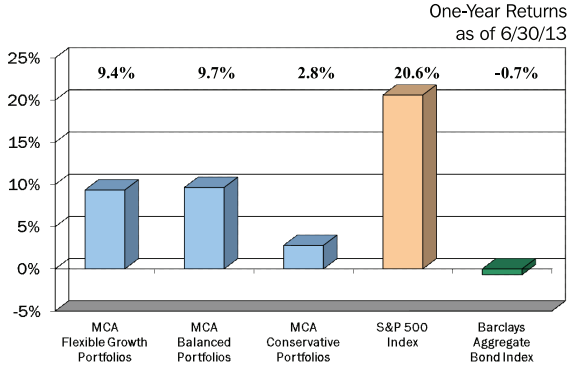
MCA FLEXIBLE PORTFOLIO TOP 20 STOCKS

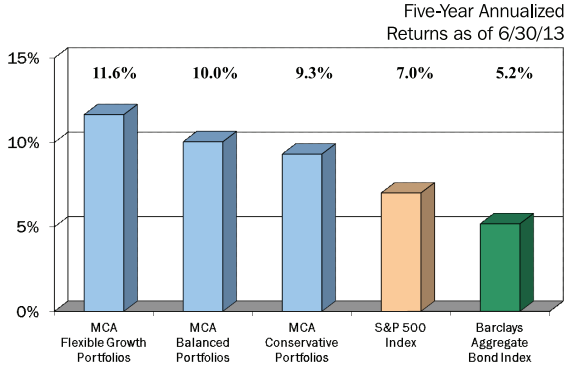
as of June 30, 2013

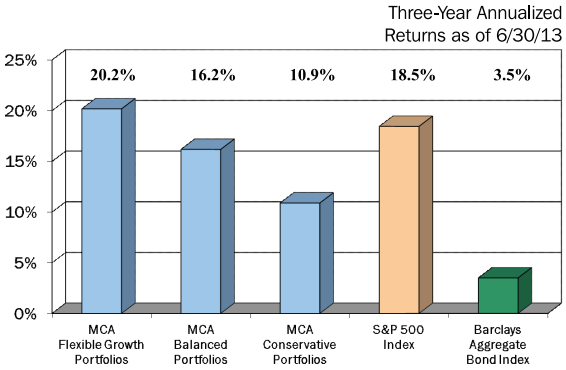
1	Apple	396.53	6	Oracle	30.71	11	Texas Instruments	34.85	16	Caterpillar	82.49
2	Whole Foods Market	51.48	7	DaVita	120.80	12	Cisco Systems	24.34	17	Ebay	51.72
3	Starbucks	65.51	8	Charles Schwab	21.23	13	Mastercard	574.50	18	Costco	110.57
4	Intuitive Surgical	506.13	9	SanDisk	61.10	14	OmniVision	18.65	19	Visa	182.75
5	Williams-Sonoma	55.89	10	Tiffany	72.84	15	Intel	24.23	20	Blackrock	256.85

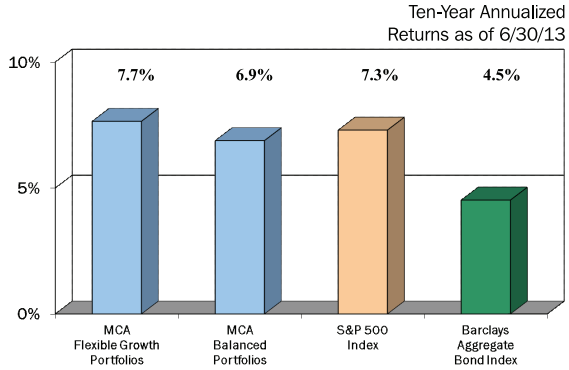
INVESTMENT RESULTS

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 6/30/2013, the *MCA Flexible Growth/Balanced/Conservative* returns represent, respectively, 31/6/2 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.