THE COMPASS

October 2013

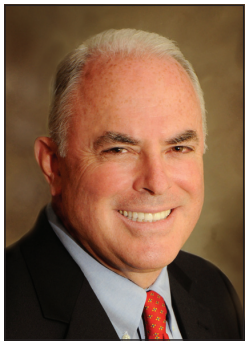
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

"It was the best of times, it was the worst of times…"

October 16, 2013

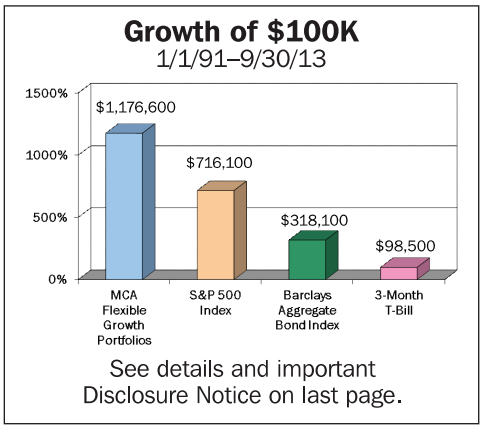
Third quarter stock market returns were very strong, with the S&P 500 rising over 5%, while MCA Flexible Growth Portfolios climbed 8%, continuing to confirm the bull market hypothesis that I have talked about for several years. Although MCA Flexible Growth Portfolios have not gained as much as the S&P 500 for the last year, longer-term returns are still quite strong, as shown in the three-year and five-year charts on page four of this newsletter. Bonds, as represented by the Barclays Aggregate Bond Index, eked out a meager 0.6% return for the quarter, but remained in negative territory year-over-year, with a -1.7% total return. Gold rebounded from multi-year lows during the quarter, posting a solid 7.6% return, but still down over 30% since 2011.



Despite the uncertainty of the government shutdown and the debt ceiling debate, as we enter the fourth quarter stocks are rallying to new highs, while Treasury bond and gold prices are slightly lower. Although the quarter has begun in line with my long-term expectations of higher stock prices and lower prices for bonds and gold, there is some risk that stocks may retreat in the short-term and that bonds and gold may continue to recover some of their losses of the past year.

As Charles Dickens said in *A Tale of Two Cities*, "It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was great the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us…" – and so it goes into the twenty-first century. And even so, stock markets reach new highs, babies are born, and the earth continues to revolve around the sun!

Now that it looks like the financial markets will have a brief reprieve from the craziness of the last few months, it's still hard to say where the markets will go in the near-term; however, I remain bullish on stocks and bearish on bonds and gold for the long-term, and I continue to recommend skewing investment portfolios towards stocks and away from bonds and gold.



COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to September 30, 2013

	Martin Capital Advisors[1]	S&P 500	Wilshire 5000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
Total[2]	1176.6%	716.1%	787.3%	318.1%	98.5%	74.8%
Avg.[3]	11.9%	9.7%	10.1%	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. ——

QUARTERLY ECONOMIC REVIEW by Colton Krueger, Investment Analyst

October 9, 2013

U.S. economic growth accelerated in the second quarter to an annualized rate of 2.5 percent, which was more than double the previous quarter. Growth continues to be driven by the housing sector and resilient consumer spending, but this quarter was helped by an improving global economic landscape and also a pickup in business spending on inventories. (Figure 1)

September's labor report was not released due to the government shutdown. For the month of August, the unemployment rate fell to 7.3 percent, which is the lowest level since December 2008. The drop in the unemployment rate, however, was in large part due to 312,000 people exiting the labor force, and not due to a particularly strong jobs report. In fact, the economy added an average of 148,000 jobs between June and August, which was lower than the monthly average of 182,000 jobs in the second quarter and the monthly average of 207,000 in the first quarter. The labor participation rate has fallen to 63.2 percent, a fifty year low. Going forward, the unemployment rate should continue to steadily trend downwards as initial unemployment claims have fallen considerably this year. In September, claims dropped to a six year low of 294,000 – last year jobless claims were above 400,000. (Figure 2)

After rising sharply during the first half of the year and reaching a high at the beginning of September, bond yields have fallen and stabilized. The 10-year Treasury note rose to as high as 2.98 percent on September 5th from as low as 1.66 percent in May, but fell precipitously once the Fed announced that it was not going to begin to taper – the 10-year now sits around 2.65 percent. Inflation continues to be modest with the CPI up 1.5 percent year-over-year and core-CPI up 1.8 percent. (Figure 3)

Rising yields caused an increase in mortgage rates earlier this year. These climbing rates did have a cooling effect on housing market; however, sales of new and existing home sales continue to be strong, especially in comparison to a year ago. New home sales are 12.4 percent greater than last year and housing starts are up 19 percent. Construction spending is also healthy and is 5.2 percent higher compared to a year ago. Home prices in the Case-Shiller 20-city index gained 12.4 percent in the last year, and this appreciation is a powerful stimulus for the economy. (Figure 4)

Green shoots are beginning to show in Europe, which snapped its 18-month recession by recording growth of 0.3 percent in the second quarter. The improvement in Europe and a pickup in China contributed to the ISM manufacturing index rising to 56.2 – the highest reading since April 2011. However, durable goods orders, which reached the highest reading ever in June, have fallen sharply as businesses have cut spending on capital equipment, likely due to the economic uncertainty caused by Washington.

Rising stock market returns and improving home prices have pushed household wealth to an all time nominal high of $74.8T. The wealth effect, along with steadily increasing personal incomes, is contributing to an increase in consumer spending and retail sales. Personal incomes have risen every month this year, and retail sales have risen for five straight months. Healthy car sales continue to be a major contributor and were particularly strong this past summer. Sales in August were up 20 percent compared to last year and recorded an annualized rate of over 16 million. The pickup in consumer spending is being reflected in the ISM demand for services, which reached an eight-year high in August of 58.6.

As we head into the fourth quarter of 2013, some of the challenges that we once faced are becoming resolved. Earlier this year, US GDP was dampened by a weak global economy, and now world economies have begun to show signs of a turn. Furthermore, markets were volatile around the actions of the Fed, but this volatility has subsided as the central bank has proven it will be extremely cautious in removing stimulus. Optimistic consumers continue to lead the economy, feeling wealthier from stock and home price increases, and being able to stretch their dollar in this low inflationary environment. Strong consumer spending leads the way for business spending, which is following suit as businesses have begun to grow inventories. The government shut down and the risk of the US defaulting on its debt is the main roadblock, and this roadblock has the power to derail our economy and the entire global economy. Fortunately, it's a manufactured crisis that will end when reason and pain trump ego. As we finish this year and look to the next, our economy is the healthiest it's been in over half a decade. This strength coupled with low interest rates and low inflation should help bring GDP growth to healthy levels next year, which will in turn improve the labor market.

ECONOMIC CHARTS

as of September 30, 2013

Figure 1

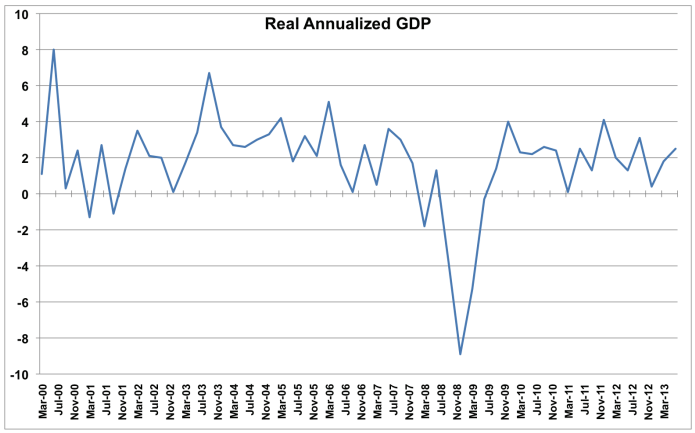


Figure 2

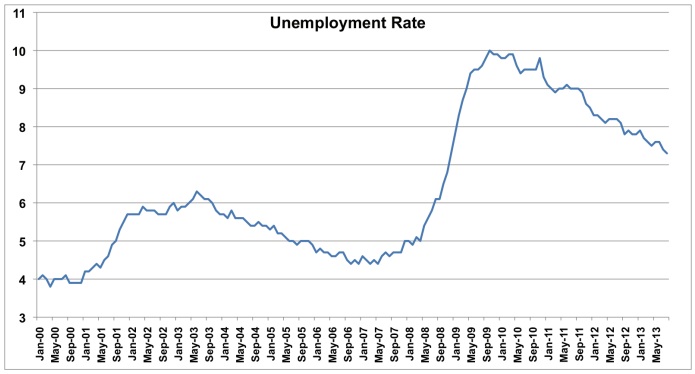


Figure 3

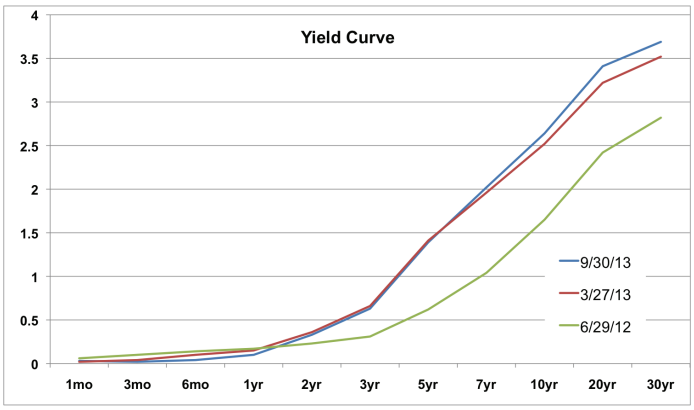
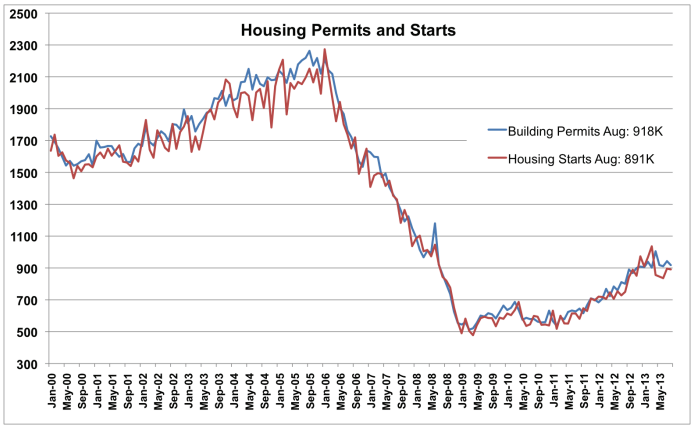


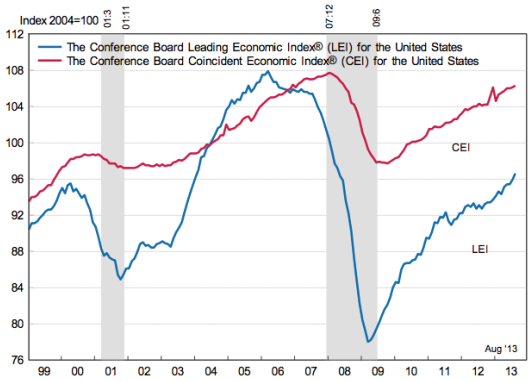
Figure 4



LEADING ECONOMIC INDICATORS

as of September 19, 2013

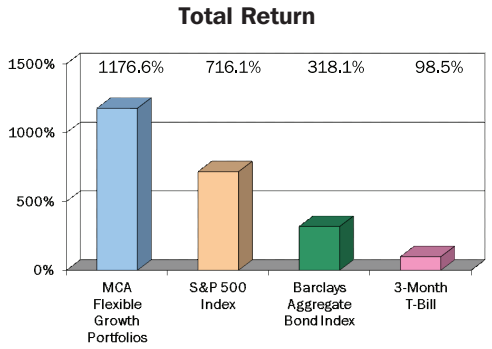
	Current Reading	1-month change	6-month change
Conference Board Leading Economic Index	96.6	0.0%	2.0%
S&P 500	1670	0.1%	10.4%
Average weekly hours, manufacturing	41.9	0.2	0.0
Initial Jobless Claims	328K	-13K	-21K
Manufacturers' new orders, capital goods ex. aircraft	41.5B	2.0%	3.1%
Manufacturers' new orders, consumer goods and materials	131.0B	0.1%	1.3%
ISM New Orders	63.2	4.9	5.4
Building Permits	918K	-3.7%	-3.7%
Spread between 10-yr Treasury Note and Federal Funds Rate	2.66	0.17	0.83
Avg. Consumer Expectations for Business Conditions	0.1	-0.13	0.60
Leading Credit Index (negative readings are positive for the LEI)	-1.51	0.36	-0.29

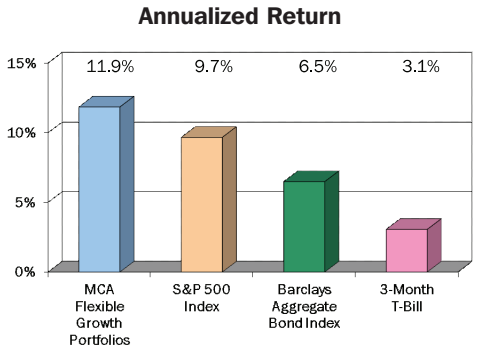


Latest LEI Trough March 2009, Latest CEI Trough October 2009
Shaded areas represent recessions as determined by the National Bureau of Economic Research.
Source: The Conference Board

RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to September 30, 2013





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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.

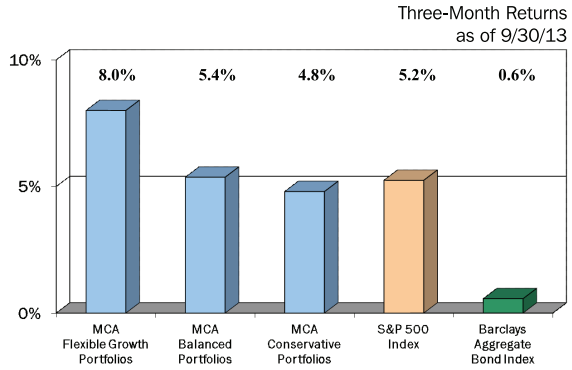
MCA FLEXIBLE PORTFOLIO TOP 20 STOCKS

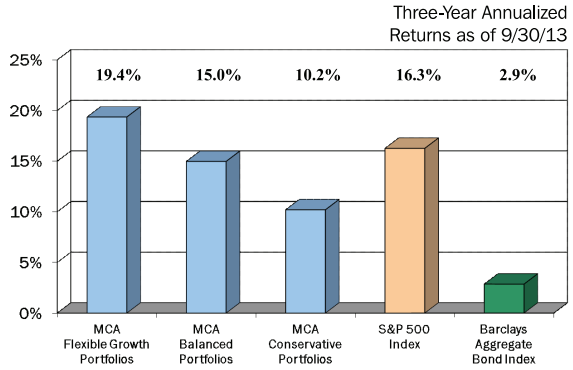
as of September 30, 2013

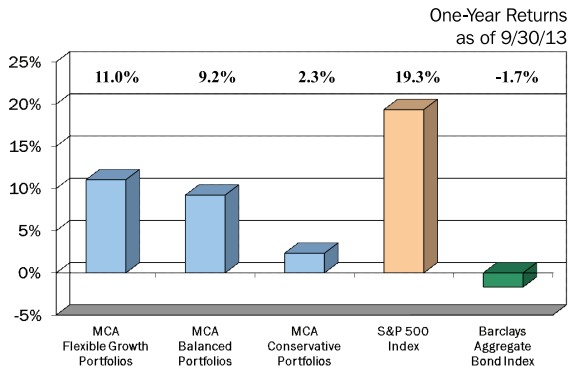
1	Apple	476.75	6	Intuitive Surgical	376.27	11	SanDisk	59.51	16	Caterpillar	83.40
2	Whole Foods Market	58.50	7	DaVita	56.90	12	Mastercard	672.78	17	Visa	191.10
3	Starbucks	76.97	8	Charles Schwab	21.14	13	Cisco Systems	23.43	18	Costco	115.17
4	Oracle	33.17	9	Texas Instruments	40.29	14	Ebay	55.80	19	Blackrock	270.62
5	Williams-Sonoma	56.20	10	Tiffany	76.62	15	Intel	22.92	20	OmniVision	15.31

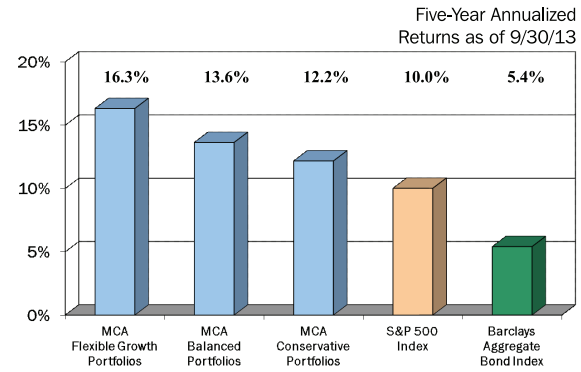
INVESTMENT RESULTS

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 9/30/2013, the *MCA Flexible Growth/Balanced/Conservative* returns represent, respectively, 30/5/2 individual portfolios and 65%/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.