THE COMPASS

April 2014

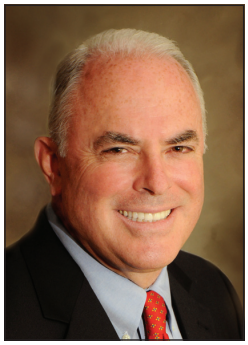
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

2014 Gets Off to a Slow Start as Stocks Digest 2013 Gains

April 26, 2014

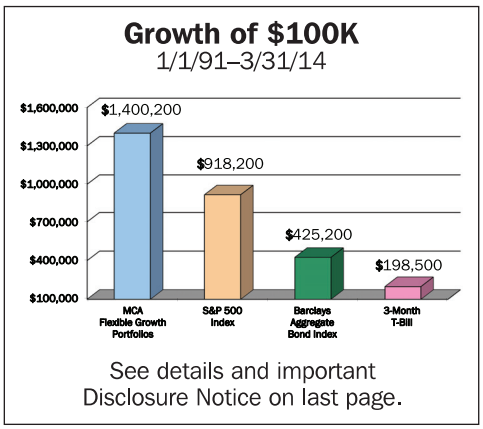
The year has begun with fairly flat returns for most stock market indexes as large gains in 2013 are being digested. So far, the second quarter has mirrored the brief stock market rallies and corrections experienced in the first quarter and I think that there is a fair chance that this "backing and filling" may continue for a while. However, in light of the strong yield curve, the probability of a recession anytime in the next few years remains extremely low, so investors should simply ride out any short-term corrections in order to fully participate in the higher returns that will likely be generated as the economy continues to expand under the protection of a highly accommodative Federal Reserve.



Gold and fixed income returns have bounced back a bit from last year's losses, as anticipated in last quarter's newsletter, and may continue to rebound in the near-term, but they probably will not do well over the next several years. The long-term declines in these assets that are well underway suggest that a reversion to the mean process has begun and will most likely result in significantly lower prices down the road.

Conflict in the Ukraine may weigh on stock prices and elevate gold and fixed income prices in the near-term, but the effect will probably be short-lived, since it is very unlikely that the conflict will spread outside of Ukraine, just as the 2008 Georgian-Russian crisis did not spread to other nations. A sell-off in stocks in reaction to the Ukrainian-Russian crisis should be viewed as a buying opportunity, and a conflict related spike in gold and fixed income securities should prove to be a great opportunity to lessen exposure to those assets.

At around 15 times next year's earnings projections for the S&P 500, stocks are still quite cheap relative to inflation and interest rates. Of course, as inflation and interest rates rise over the next ten to twenty years, stocks eventually will be negatively impacted, as we saw in the 1970s, but that day is a long way off in the future. Therefore, at this point, an investor's time would be better spent analyzing companies, which is our focus at Martin Capital, rather than trying to predict and react to the next stock market correction.



See details and important Disclosure Notice on last page.

COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to March 31, 2014

	Martin Capital Advisors[1]	S&P 500	Wilshire 5000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
Total[2]	1300.2%	818.2%	896.1%	325.2%	98.5%	75.5%
Avg.[3]	12.0%	10.0%	10.4%	6.4%	3.0%	2.5%

[1]Total performance, net of commissions, fees, and expenses of all Martin Capital Advisors' *Flexible Growth Portfolios.*
[2]Total compounded return, including reinvestment of dividends and interest. [3]1991-2014 annualized return.

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

The harsh winter that began over 6 months ago in many parts of the country cooled the economy in the fourth quarter 2013 and first quarter 2014, but as winter begins to thaw, the green shoots of the U.S. economy remain intact and appear to be firmly rooted in the soil of a steadily improving labor market and an accommodative Fed. In the fourth quarter 2013, the economy grew at an annualized rate of 2.6 percent, which was a sharp decline from the 4.1 percent rate recorded in the previous quarter, and projections for the first quarter hover in the 2 percent range. **(Figure 1)**

March marked the first time the number of private sector jobs passed their pre-recession peak. The labor department reported an increase of 192,000 jobs in the number of private sector jobs in March, revised February's number upward, and recorded a pickup in the labor participation rate. This momentum looks like it will continue in the months ahead. The number of job openings is at the highest point since January 2008 with roughly 2.5 people unemployed for every open job. To put this in perspective, in July 2009 this ratio peaked at 6.7 unemployed people for every open job. Furthermore, last week's applications for unemployment benefits fell to 300,000, which is the lowest level since May 2007. **(Figure 2)**

One potential threat to the momentum in the labor market is if the Fed decides to raise rates prematurely. The last time the Fed provided guidance on when it might raise rates was in December 2012 when they stated that low rates would continue "at least as long as the unemployment rate remains above 6.5 percent". However, as we approach this threshold, it's becoming increasingly clear that the Fed will likely sustain its zero interest rate policy into 2015. The new Fed chair, Janet Yellen, is considered to be more of a dove than a hawk on monetary policy, insofar as she is focused more on continuing to bring down unemployment rather than fighting inflation, at least for now.

The Fed will likely remain accommodative as long as inflation remains weak. At this point, the economy is still more threatened by deflation. The CPI and Core CPI are up 1.5 percent and 1.7 percent respectively in the past year and have been below the Fed's target rate of 2 percent for the last two years. Furthermore, the personal consumption deflator, which the Fed watches closely, has only increased 0.9 percent in the last year and has slowly declined since reaching a peak of 2.9 percent in September 2011. Globally, many of the world's economies are teetering on deflation. On average across Europe, consumer prices are up 0.5 percent compared to a year ago, with countries like Greece, Spain, and even Sweden experiencing declines in prices. Japan, which enacted aggressive economic policies in November 2012 to stimulate its economy, is also struggling to create inflation. **(Figure 3)**

Although low prices increase consumer's purchasing power, when prices decline and become too low there can be a devastating effect. The effect is in part psychological – consumers and businesses see declining prices and anticipate that in the future prices will be lower so they delay their purchases, weakening the economy. As prices decline, so too do wages, which further decreases spending and this creates a vicious cycle that is hard to break. Fortunately, U.S. consumers and businesses are quite optimistic about future economic conditions. In March consumer confidence rose to the highest level since July of last year, and the consumer sentiment index of expectations six months from now jumped to the highest levels since August. **(Figure 4)**

An improving labor market should help boost inflation. As the labor market strengthens and the demand for labor increases, laborers gain bargaining power and the ability to demand higher wages. As wages increase, companies increase their prices to retain their profit margins, and consumers are able to stomach the hike in prices because they are earning more. Other than inflation and the unemployment rate, one key metric to watch in anticipation of when the Fed might begin to raise rates is average weekly earnings. In the past year, average weekly earnings are up 2 percent with a 0.5 percent jump occurring in March. Not coincidentally, given the tie between wages and prices, in March producer prices jumped 0.7 percent, which was the largest increase since January 2010.

As we move into the second quarter of 2014, the Fed expects inflation, GDP, and the labor market to strengthen. This past winter is being viewed as a temporary blip in the recovery caused by severe weather. Time and time again our economy, despite the modest recovery, has shown remarkable resiliency in the face of both natural and manmade challenges. Going forward, we should expect gradually to return to normalcy as the labor market recovers with the wind of the Fed's accommodative policy continuing to be behind the economy.

ECONOMIC CHARTS

as of March 31, 2014

Figure 1

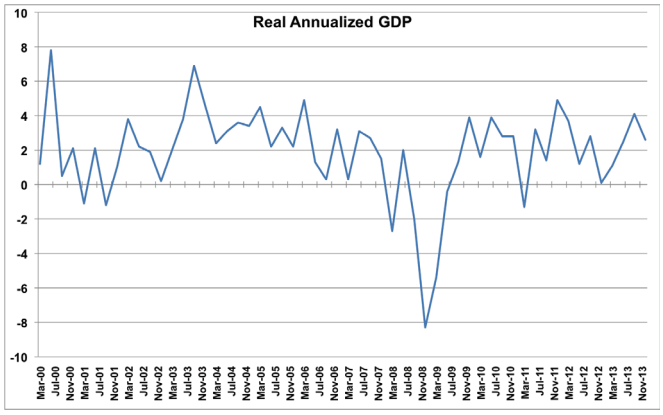


Figure 2

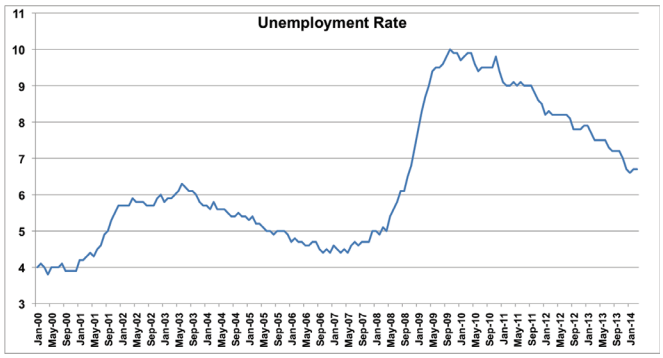


Figure 3

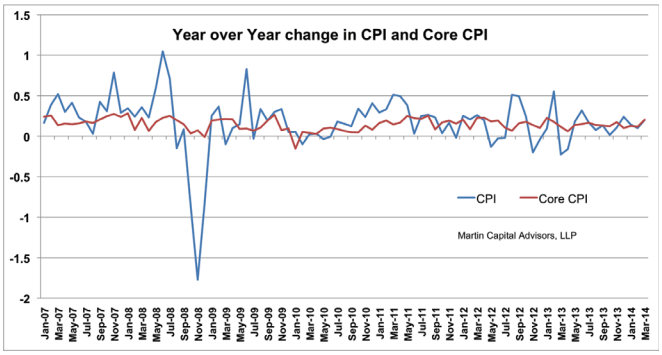
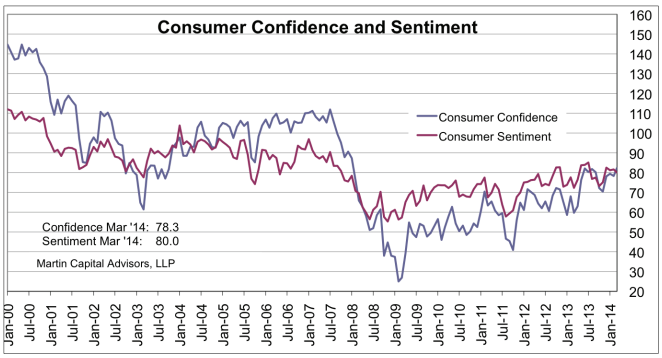


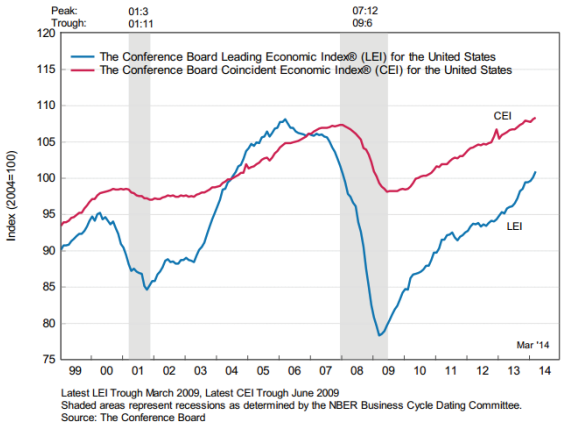
Figure 4



LEADING ECONOMIC INDICATORS

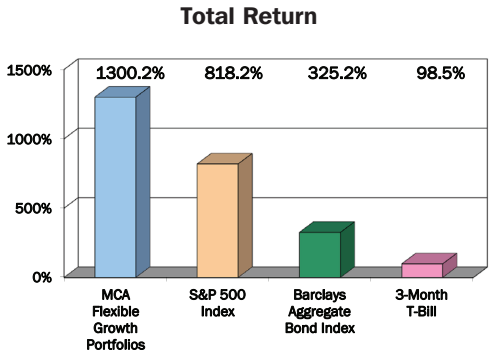
as of April 21, 2014

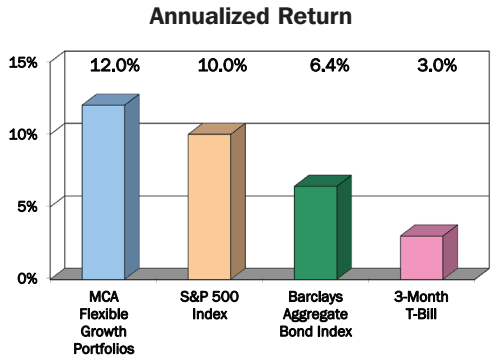
	Current Reading	1-month change	6-month change
Conference Board Leading Economic Index	100.9	0.8%	2.7%
S&P 500	1863	2.5%	10.4%
Average weekly hours, manufacturing	42.0	0.4	0.1
Initial Jobless Claims	320.9K	-16K	+6K
Manufacturers' new orders, capital goods ex. aircraft	41.1B	0.9%	+0.6%
Manufacturers' new orders, consumer goods and materials	132.1B	0.0%	-0.7%
ISM New Orders	55.1	0.6	-6.2
Building Permits	990K	-2.3%	1.6%
Spread between 10-yr Treasury Note and Federal Funds Rate	2.64	0.0	-0.09
Avg. Consumer Expectations for Business Conditions	-0.12	0.22	-0.07
Leading Credit Index (negative readings are positive for the LEI)	-1.54	+0.24	+0.03



RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to March 31, 2014





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Martin Capital Advisors, LLP, is a registered investment advisor managing private and institutional investment portfolios.

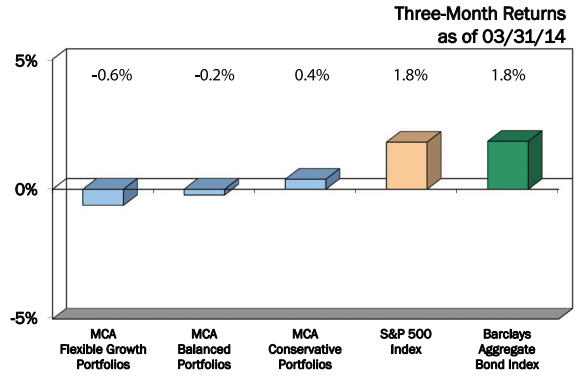
MCA FLEXIBLE GROWTH PORTFOLIOS TOP 20 STOCKS

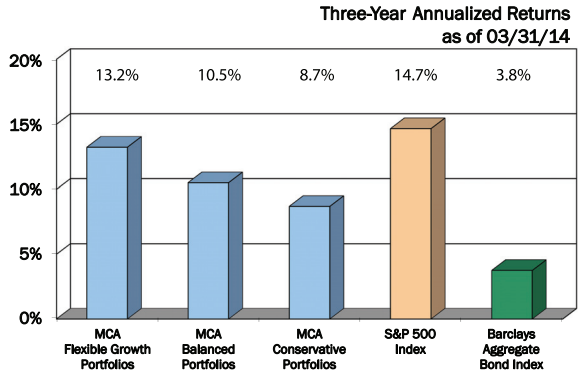
as of March 31, 2014

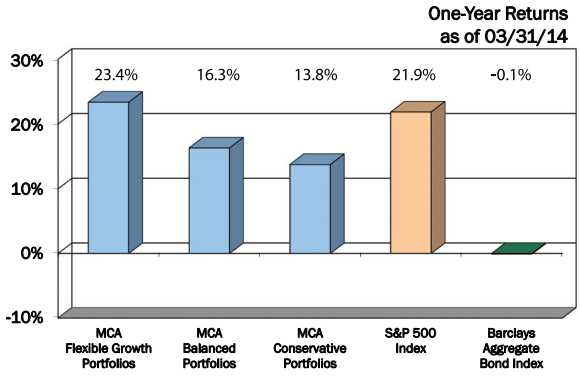
1	Apple	536.74	6	Intuitive Surgical	437.99	11	Tiffany	86.15	16	Intel	25.81
2	Whole Foods Market	50.71	7	Charles Schwab	27.33	12	Mastercard	74.70	17	BlackRock	314.48
3	Starbucks	73.38	8	SanDisk	81.19	13	Cisco Systems	22.42	18	OmniVision	17.70
4	Oracle	40.91	9	DaVita	68.85	14	Visa	215.86	19	Google	1114.51
5	Williams-Sonoma	66.64	10	Texas Instruments	47.16	15	Caterpillar	99.37	20	Costco Wholesale	111.68

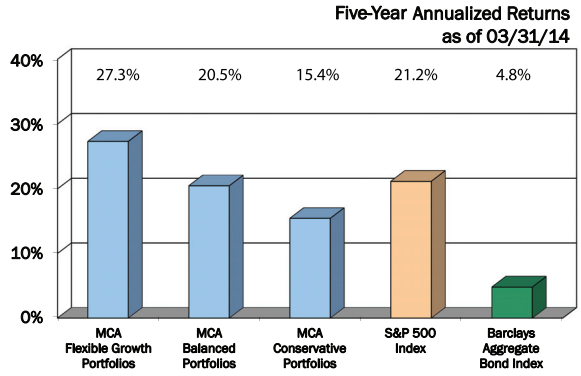
INVESTMENT RESULTS

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 Advisors, LLP (MCA) composite returns are net of all fees and expenses. From time to time composite 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 3/31/2014, the MCA Flexible Growth/Balanced/Conservative Portfolios' returns represent, respectively, 31/5/1 individual portfolios and 65%/29%/3% of all funds under management by MCA. Clients explicitly elect these management styles on their Personal Data Form. The MCA Flexible Growth Portfolios are managed for capital appreciation, and the MCA Balanced and Conservative Portfolios are managed for capital appreciation and income. Independent performance reporting is provided by CGM Investment Management.

MCA claims compliance with the Global Investment Performance Standards (GIPS) and has prepared and presented this report in compliance with the GIPS standards. The listed composites contain all fee-paying accounts with an investment strategy as indicated by the composite title. Non-fee paying or nondiscretionary portfolios are excluded from the composites, but are included in the definition of total firm assets. Performance results are expressed in U.S. dollars. Performance returns are considered PRELIMINARY numbers until examined according to GIPS for the reporting period. To receive a complete list and description of Martin Capital composites and a presentation that adheres to the GIPS standards, contact Paul Martin at (210) 694-2100, ext. 1, or paul@martincapital.com.