# THE COMPASS

July 2014

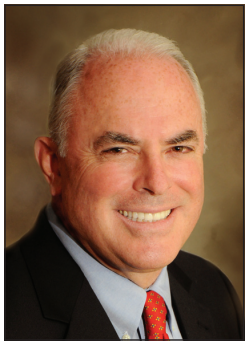
A Quarterly Newsletter of Martin Capital Advisors, LLP


## INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

### Despite International Tensions and Mixed Economic Reports, Long-Term Prospects for Stocks Remain Bullish

*July 29, 2014*

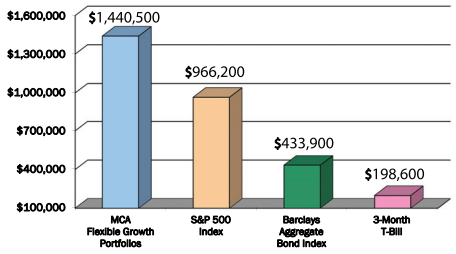
Most stock market indexes have achieved positive returns this year despite ongoing international tensions and a variety of other concerns, such as a drop in first quarter GDP. Small-cap stocks, however, as represented by the Russell 2000, are down slightly year-to-date. Since the beginning of the year there has been a flight to larger-cap companies and defensive sectors, such as utilities, in reaction to mixed economic signals. Bonds and gold have also benefited from this uncertainty. Essentially, there has been a more conservative bias in the market so far this year. As GDP rebounds in the second quarter and other indicators, such as jobless claims continue to improve, we should see investments begin to flow back into smaller-cap companies and more economically sensitive stocks, such as in the consumer discretionary sector.



So, from my point of view, it's really just a matter of time before better relative performance shifts back from defensive sectors, bonds, and gold into more economically sensitive investments like consumer discretionary stocks. Quite frankly, I think that the "conservative" investments that many investors have gravitated toward this year may prove to be a lot more volatile than many realize – especially long-term Treasury bonds. As the Fed gradually responds to improving economic conditions, particularly on the labor front, and accelerates the withdrawal from quantitative easing, the bond bubble could deflate even more than the almost 15% drop that hit Treasury bonds in 1994. Gold and interest sensitive stocks, utilities being at the head of the list, should also not fare well as the winter's economic malaise subsides and the economy picks up for the rest of the year.

The bottom line is that worries about the prospects for the economy have been exaggerated, perhaps largely in reaction to the aberrant first quarter decline in GDP. However, the Fed remains extremely accommodative and the economy now appears to have shrugged off the weather related weakness in the beginning of the year and looks to be back on track for sustainable growth throughout the rest of the year. Although even in an expanding economy a stock market correction can happen at any time, the resumption of improving economic activity in the second quarter augurs well for the performance of most stocks for the foreseeable future. This does not necessarily mean that the stock market will be higher at the end of the year, because there is always the possibility that an unexpected negative short-term catalyst could briefly weigh on the market, but I am confident that investors in equities will continue to be well rewarded over the next few years.

**Growth of $100K**
1/1/91–6/30/14




See details and important Disclosure Notice on last page.

## COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to June 30, 2014

| | Martin Capital Advisors[1] | S&P 500 | Wilshire 5000 | Barclays Aggregate Bond Index | 3 Month T-Bill | Consumer Price Index |
|---|---|---|---|---|---|---|
| Total[2] | 1340.5% | 866.2% | 944.3% | 333.9% | 98.6% | 77.8% |
| Avg.[3] | 12.0% | 10.1% | 10.5% | 6.5% | 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. ——

Last month the U.S. stock market shook off what is arguably the worst economic data reading in the last five years. After the cold winter, economists predicted that GDP would contract, but they were shocked when the figure came in at negative 2.9 percent. Despite being the worst reading since 2009 and the steepest drop outside of a recession since WII, the market brushed off the dismal figure as an anomaly. Instead, the markets have been rallying behind a strong labor market and a renewed housing recovery. This strength has many believing that we are finally entering a period of normal economic growth after five years of inconsistent growth. **(Figure 1)**

After the poor GDP reading in June, there were high expectations for June's employment report to deliver good numbers. The labor report did not disappoint and handily beat expectations, showing that the economy added 288,000 jobs and the unemployment rate dropped from 6.3 to 6.1 percent. Since January the labor market has added an average of 231,000 jobs per month for the best first half since 1999, and the total number of jobs gained in the last year has topped 2.5 million. **(Figure 2)**

Housing led the economic recovery in 2012, often picking up the slack when the labor market was muttering along. However, in the second half of last year, the housing recovery grew stagnant as mortgage rates began to climb and the sharp increase in home prices caused many homebuyers, especially first-time homebuyers, to stand on the sidelines. Recently, the housing market has shown a trend in recovery. New home sales spiked 18.6 percent in May to a six year high, and existing home sales were up 4.9 percent, recording the best gain since 2011. The data from pending home sales, which gives a forecast of home-buying activity in the coming months, suggests that the recovery will continue. However, this past week data on housing starts and building permits for June disappointed expectations. Housing starts sank 9.3 percent and building permits also stumbled. The drop is likely a temporary aberration of the trend in the housing market recovery and is being blamed on wet weather in the southern part of the country.

The broad improvements in the labor and housing markets have caused many economists to believe the Fed will begin raising rates sometime in the second half of 2015. While some pundits and Fed governors are calling for action sooner than later, the Fed continues to justify its zero interest rate policy primarily by pointing to inflation remaining below two percent and weak wage growth. Moreover, consumer spending has been very restrained, putting a damper on the recovery. Personal consumption increased just 0.2 percent in May following no change in April, and weak consumer spending has weighed on retail sales. Spending makes up over two-thirds of the economy, and the weak readings have caused economists to bring down their GDP predictions for the second quarter to around 2.5 percent. If the reading comes in at this rate then the economy will have recorded a net contraction for the first half of 2014. **(Figure 3)**

There are reasons to be optimistic that consumer spending will accelerate in the second half of the year. Personal incomes have been increasing lately and are outpacing the rate of inflation, causing an overall increase in purchasing power. In addition the improvements in the labor market have caused consumers to feel more confident about economic conditions. In June consumer confidence rose to the highest reading since January 2008, but is still well below the peak reached in 2007.

The consensus about the bond market six months ago was that yields were going to climb as the Fed continued tapering its bond-buying program. As usual the consensus was wrong: despite the stock market rally, yields on the 10-year Treasury logged their biggest first half drop since 2010, closing at 2.53 percent on June 30, down from 2.73 percent on March 31 and 3.04 percent at the end of 2013. While the overall yield curve remains relatively steep, falling long-term Treasury rates have led to some flattening of the yield curve. The falling yields have also lowered borrowing costs, which has likely contributed to the recent pick-up in the housing market and the flurry of M&A activity. **(Figure 4)**

As we enter the second half of 2014 there is a lot to be optimistic about regarding the U.S. economy, perhaps more so than at any point during this recovery. The key barometer to pay attention to going forward is consumer spending and other associated metrics. We will not be able to reach sustained economic growth with consumers on the sidelines and wage growth weak. As we head into the corporate earnings season, the weak consumer will be a theme in many corporate commentaries. The recent market rally has largely been a result of multiple expansion rather than earnings growth. Fortunately all signs point to consumer spending picking up, which will help economic and earnings growth.

## ECONOMIC CHARTS

as of June 30, 2014

**Figure 1**

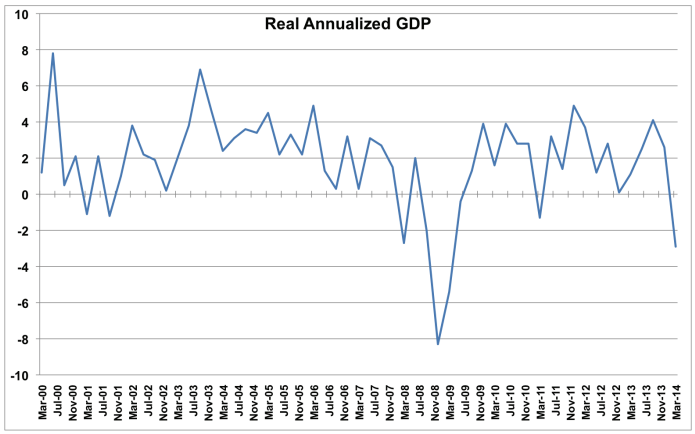



**Figure 2**

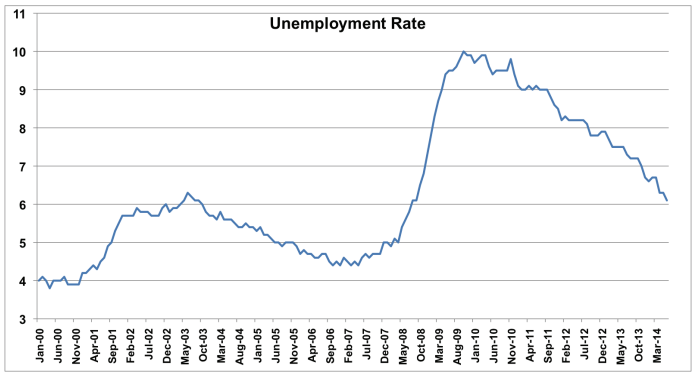



**Figure 3**

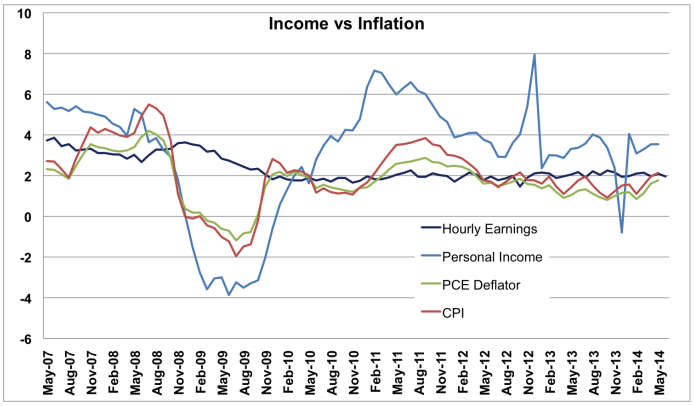
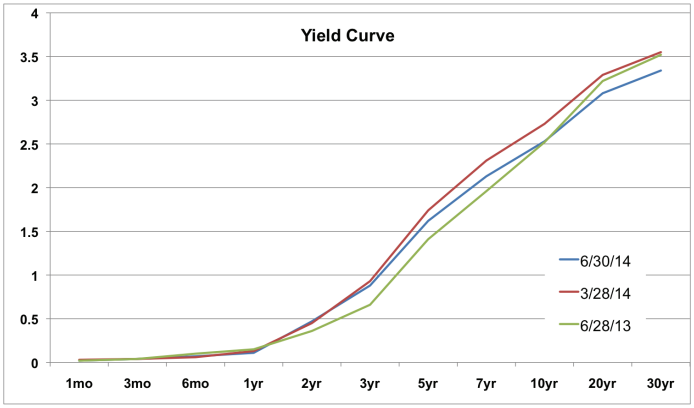


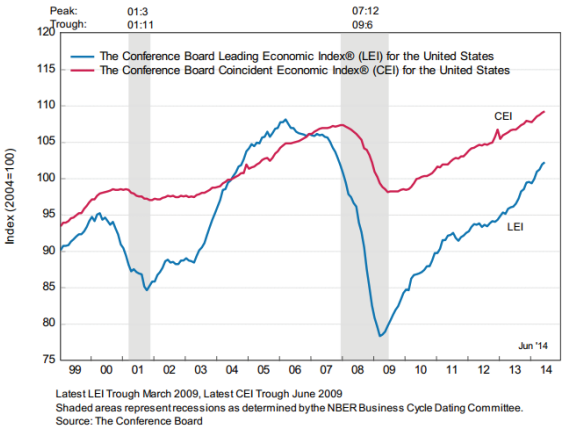

**Figure 4**




## LEADING ECONOMIC INDICATORS

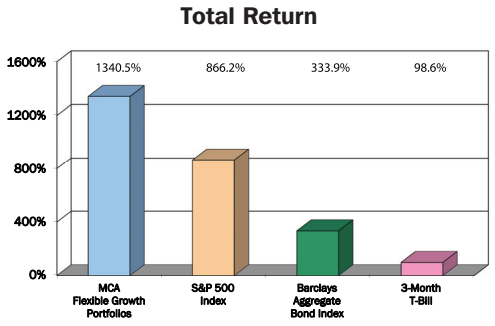
as of July 18, 2014

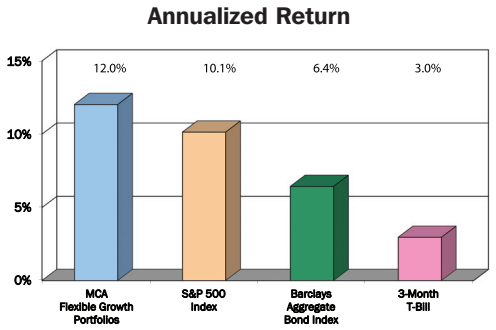
| | Current Reading | 1-month change | 6-month change |
|---|---|---|---|
| Conference Board Leading Economic Index | 102.2 | 0.3% | 2.7% |
| S&P 500 | 1947 | 3.1% | 7.7% |
| Average weekly hours, manufacturing | 42.1 | -0.1 | 0.2 |
| Initial Jobless Claims | 315K | -4.7K | -37.3K |
| Manufacturers' new orders, capital goods ex. aircraft | 42.7B | +0.3% | +2.2% |
| Manufacturers' new orders, consumer goods and materials | 132.9B | 0.0% | 1.8% |
| ISM New Orders | 58.9 | +2.0 | -5.5 |
| Building Permits | 963K | -4.1% | -5.8% |
| Spread between 10-yr Treasury Note and Federal Funds Rate | 2.50 | +0.03 | -0.31 |
| Avg. Consumer Expectations for Business Conditions | -0.03 | -0.02 | +0.31 |
| Leading Credit Index (negative readings are positive for the LEI) | -1.75 | -0.41 | +0.09 |



## RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to June 30, 2014





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

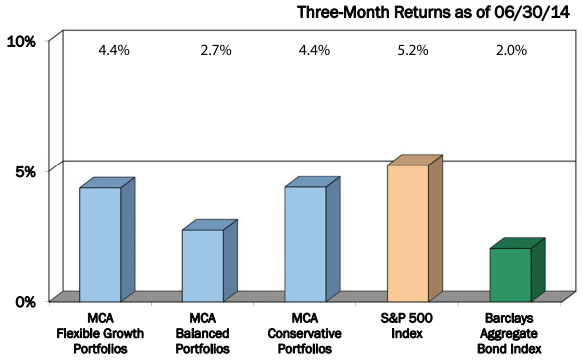
## MCA FLEXIBLE GROWTH PORTFOLIOS TOP 20 STOCKS

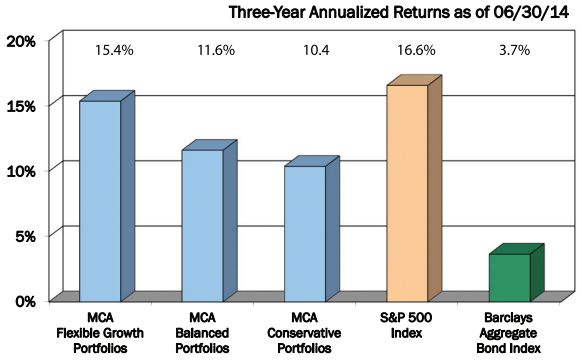
as of June 30, 2014

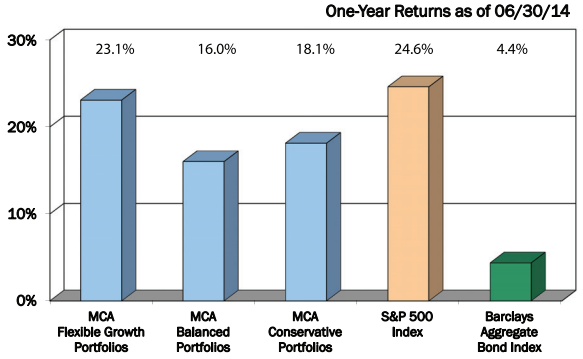
| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Apple | 92.93 | 6 | Oracle | 40.53 | 11 | Texas Instruments | 47.79 | 16 | Caterpillar | 108.67 |
| 2 | Starbucks | 77.38 | 7 | Intuitive Surgical | 411.80 | 12 | MasterCard | 73.47 | 17 | Visa | 210.71 |
| 3 | Whole Foods Market | 38.63 | 8 | Tiffany | 100.25 | 13 | OmniVision | 21.98 | 18 | Costco Wholesale | 115.16 |
| 4 | Williams-Sonoma | 71.78 | 9 | DaVita | 72.32 | 14 | Cisco Systems | 24.85 | 19 | Blackrock | 319.60 |
| 5 | SanDisk | 104.43 | 10 | Charles Schwab | 26.93 | 15 | Intel | 30.90 | 20 | IDEXX Laboratories | 133.57 |

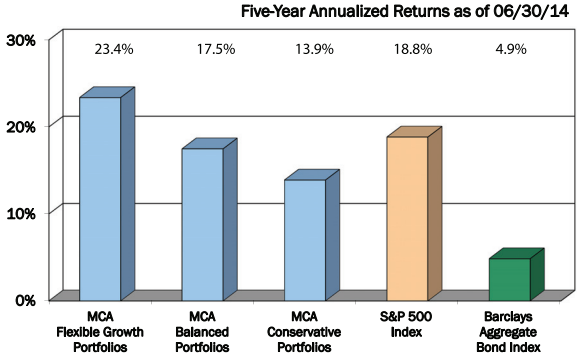
## INVESTMENT RESULTS

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 6/30/2014, the MCA Flexible Growth/Balanced/Conservative Portfolios' returns represent, respectively, 33/6/1 individual portfolios and 66%/29%/2% 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 Robert Godines at (210) 694-2100, ext. 2, or robert@martincapital.com.