THE COMPASS

October 2015

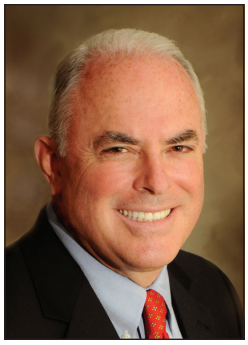
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Stocks Bouncing Back After Third Quarter Correction

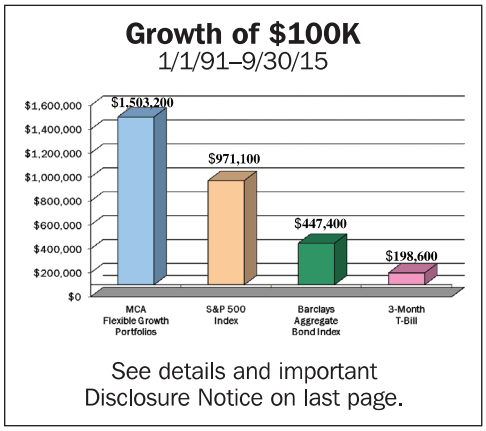
October 24, 2015

Stocks pulled back in the third quarter as concerns about the Chinese economy and uncertainty about when the Federal Reserve would begin to raise rates brought future economic growth into question. Massive program selling on August 24 signaled the kind of panic normally seen at market bottoms. As is often the case, the market retested the bottom at the end of September and has rebounded in October, approaching the previous high set in the second quarter. My guess is that the stock market will continue to work its way higher over the next few months. In any event, the economic expansion is really not in jeopardy at this point, so the bull market probably has at least a few years to go. Interestingly, in the face of recent worries about the economy, the S&P 500, year-to-date as of October 23, is outperforming the Barclays U.S. Aggregate Bond Index, the 30-year Treasury Bond, and gold.



Although the August 24 stock market "crash" was a bit unnerving, it will most likely prove to be just a program selling and herd stampeding rout that signifies nothing, similar to the 1987 crash. I was a broker with Oppenheimer and Co. in New York City during the 1987 crash, when the S&P 500 fell 22% in one day. Most investors decided that a recession must be imminent, however, to the contrary, the economy and corporate earnings did not decline and the stock market surged higher over the next few years. While the recent panic wasn't even close in scale to the 1987 crash, the negative sentiment has been eerily similar, so I think that the odds are very good that a major stock market bottom was established in August and successfully retested in September.

Fixed income investments, not stocks, pose the real threat to investors' portfolios today. Eventually, inflation will take hold again, as it did after the last deflationary period in the 1930s. From 1943 to 1983, there were only a few rolling five-year periods when Treasury Bonds achieved positive returns, adjusted for inflation. Three-month T-Bills didn't fare much better. The S&P 500, however, outperformed inflation over every five-year rolling period from 1944 until 1970, when hyper-inflation began its march into the early 1980s. This information and lot more can be found in a report on our website (www.martincapital.com) that we update annually under "Comparison of Long-Term Performance of Stocks, Bonds & T-Bills (1926 to 2014)". The bottom line is that stocks tend to do well during a reflationary period, which I believe that we are entering now, but bonds, CDs, money markets, savings accounts, and all interest bearing securities are virtually guaranteed to lose money as inflation picks up.



See details and important Disclosure Notice on last page.

COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to September 30, 2015

	Martin Capital Advisors[1]	S&P 500	Wilshire 5000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
Total[2]	1403.2%	871.1%	931.7%	347.4%	98.6%	78.1%
Avg.[3]	11.6%	9.6%	9.9%	6.2%	2.8%	2.4%

[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]1991-2015 annualized return.

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

Real annualized gross domestic product expanded at a rate of 3.9% in the second quarter of 2015, bouncing back after the contraction recorded in the first quarter. The strong rebound is now beginning to look more like a one-time blip as GDP estimates for the third quarter continue to trend down and now are tracking around 1.2%. The return to weaker growth may be a sign that the global macro uncertainty that has transpired over the last year in the currency, commodity, and financial markets could be having some effect on the U.S. economy. **(Figure 1)**

In September's labor report, nonfarm payrolls increased by 142,000, which was weaker than the 200,000 jobs that were expected. The report was especially disappointing as both August and July's payroll numbers were revised down by a combined 59,000 jobs. The unemployment rate remained at 5.1% only because the labor participation rate ticked down to 62.4%, which is near forty-year lows. **(Figure 2)**

The weaknesses internationally and strengthening of the US dollar is having the most immediate effect on the manufacturing industry. In September, the ISM Manufacturing Index fell to 50.2, recording its third straight month of decline. The stronger dollar is hurting export orders for domestically manufactured goods and this is causing a widening trade imbalance. The ISM Services Index recorded 56.9 in September, well into expansionary territory, but weaker than it has been recently.

The contraction in manufacturing and weakness in commodities is having an impact domestically as declines and layoffs in these industries cause a drag that reverberates through the economy. However, only about 12% of our GDP is from manufacturing and 70% of GDP is driven by consumer spending. Consumer spending continues to expand and is likely being bolstered by the decline in commodity prices and the stronger dollar as movements in these markets have increased consumer purchasing power. In September, retail sales recorded a gain of 0.1% and are 2.4% higher for the year.

Housing, too, remains steady, which is another very important driver of the domestic economy. While recent stock market volatility has hurt shareholders, most Americans' biggest investment is their home rather than their stock portfolio. Home prices continue to steadily increase, and prices are on average over 5% higher compared to a year ago. Both building permits and housing starts also remain strong, up 11.6% and 16.6% in the last year, respectively.

Inflation continues to be weak. In September the Fed elected to kick the can down the road on raising interest rates due to anemic inflation and economic uncertainty in China. In the last year, inflation is only up 0.2% and core inflation is up 1.8%. Globally, inflation remains weak and has turned negative in the Eurozone and in Japan. Central banks around the world continue to expand monetary policy to prop up inflation, which makes the Fed's decision to raise rates even more difficult. **(Figure 3)**

The weakness abroad is causing capital to flow into the US as investors fly to safety. This phenomenon further strengthens the dollar, creates deflationary pressure, and causes strong demand for US Treasuries. As a result, short-term T-bills are near record lows with both the 1-month and 3-month rates recently yielding 0%. Long-term rates have also contracted: the 30-year bond fell from 3.20% to 2.87% over the quarter. The decline in long-term rates is causing a flattening of the yield curve, and the 0% short-term T-Bill rates clearly indicate that the financial markets are not anticipating a rate hike by the end of the year. **(Figure 4)**

Time will tell whether our economy can absorb the declining pressure being imposed by the world's economies, but there are reasons to believe that we are better able to weather troubles abroad than the stock markets' recent correction would suggest. Most of our economy is still driven by consumer spending, which has been resilient, and most companies have very little revenue exposure to China. This is likely why the Fed said in September that it still plans to raise rates this year. Paying attention to the Fed's decision going forward will reflect just how insulated they believe we are from global pressures.

ECONOMIC CHARTS

as of September 30, 2015

Figure 1

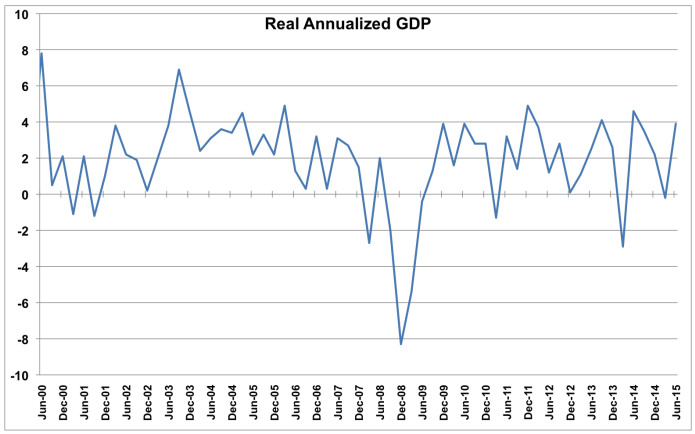


Figure 3

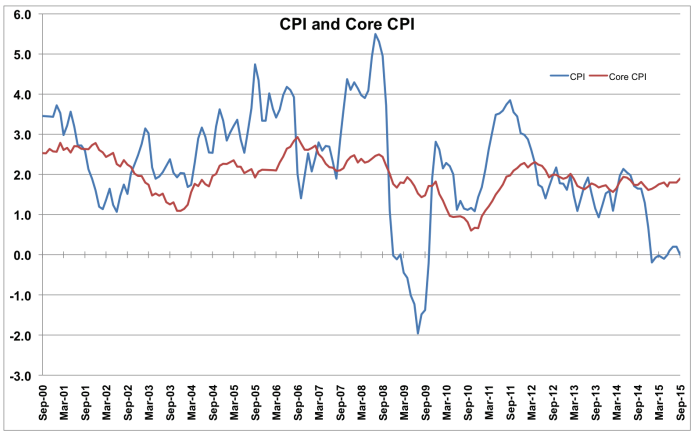


Figure 2

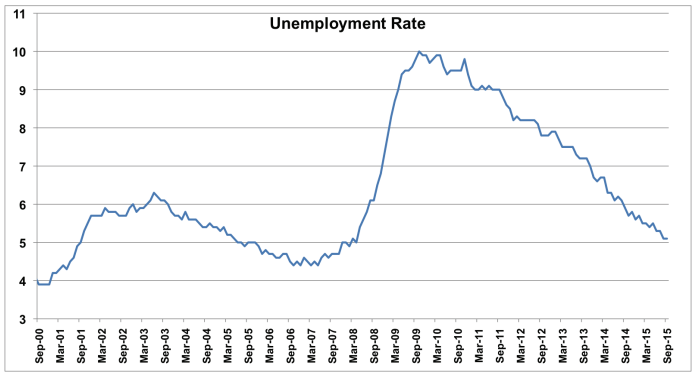
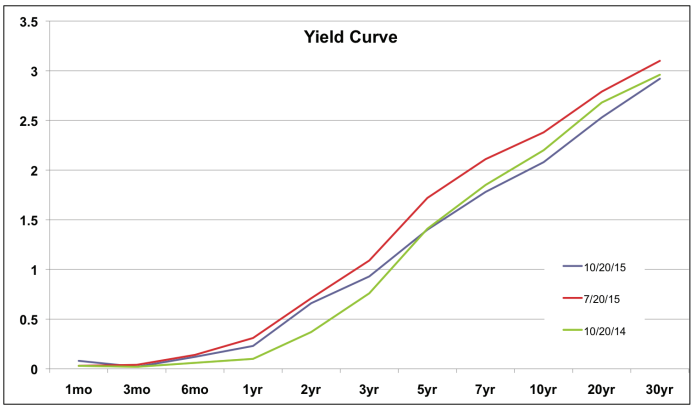


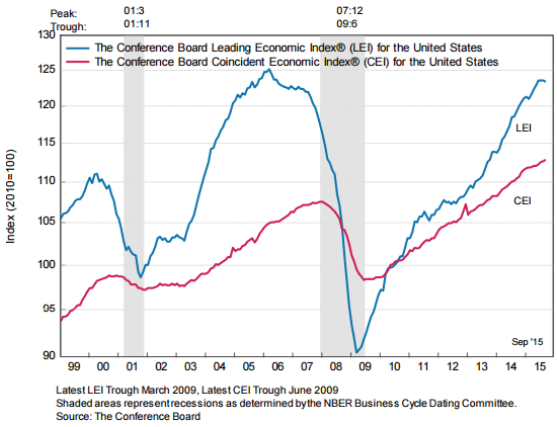
Figure 4



LEADING ECONOMIC INDICATORS

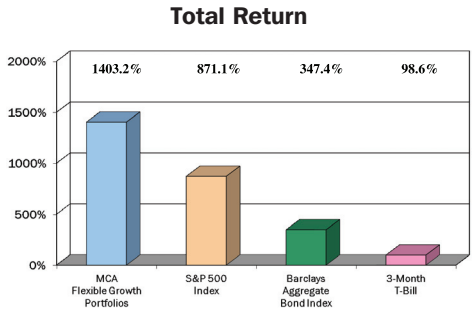
as of September 2015

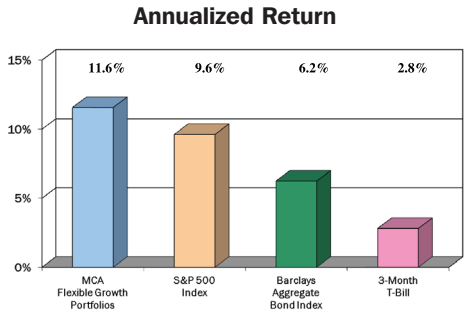
	Current Reading	1-month change	6-month change
Conference Board Leading Economic Index	123.3	-0.2%	+1.5%
S&P 500	1944	-4.7%	-6.5%
Average weekly hours, manufacturing	41.2	-0.2	-0.2
Initial Jobless Claims	267.4K	-8.1K	-18.1K
Manufacturers' new orders, capital goods ex. aircraft	41.2B	+0.3%	+1.3%
Manufacturers' new orders, consumer goods and materials	138.1B	+0.1%	+1.3%
ISM New Orders	50.1	-1.6	-1.7
Building Permits	1103K	-5.0%	+6.3%
Spread between 10-yr Treasury Note and Federal Funds Rate	2.03	unch	+0.10
Avg. Consumer Expectations for Business Conditions	0.06	-0.23	-0.40
Leading Credit Index (negative readings are positive for the LEI)	-1.17	-0.66	-0.34



RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to September 30, 2015





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

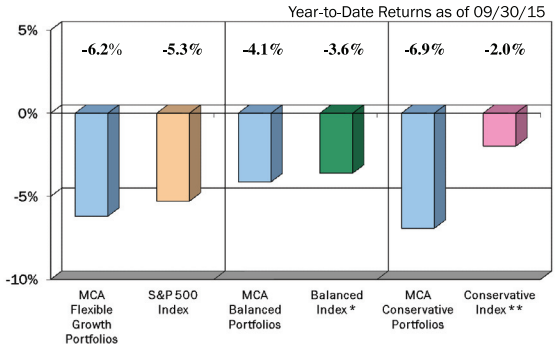
MCA FLEXIBLE GROWTH PORTFOLIOS TOP 20 STOCKS

as of September 30, 2015

1	Apple	110.30	6	Charles Schwab	28.56	11	Diamond Hill Inv. Group	186.04	16	SanDisk	54.33
2	Starbucks	56.84	7	DaVita	72.33	12	Tractor Supply	84.32	17	Costco Wholesale	144.57
3	Whole Foods Market	31.65	8	MasterCard	90.12	13	Texas Instruments	49.52	18	Alphabet	638.37
4	Williams-Sonoma	76.35	9	Oracle	36.12	14	Visa	69.66	19	ARM Holdings	43.25
5	Intuitive Surgical	459.58	10	Tiffany	77.22	15	OmniVision	26.26	20	IPG Photonics	75.97

INVESTMENT RESULTS

Martin Capital Advisors' Investment Portfolios vs. S&P 500 and Barclays Aggregate Bond Indexes



* 75% S&P 500 Index + 25% Barclays US Aggregate Bond Index
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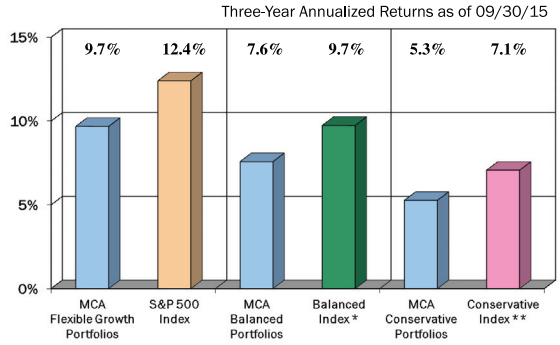

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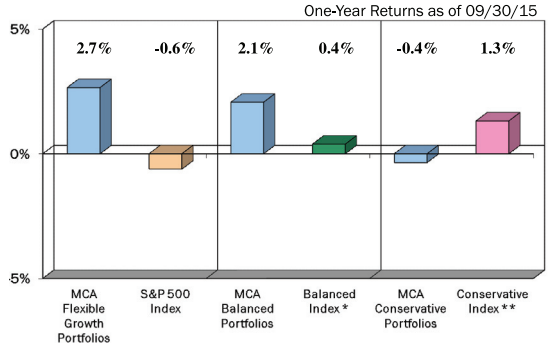

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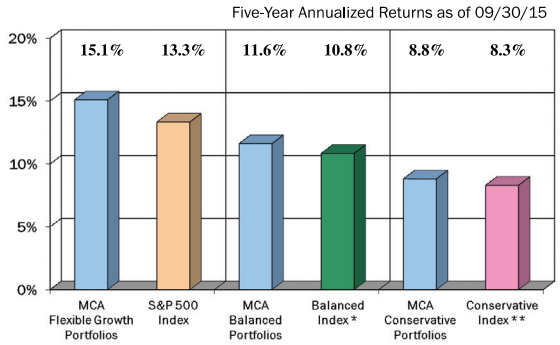

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IMPORTANT DISCLOSURE NOTICE

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 9/30/2015, the MCA Flexible Growth/Balanced/Conservative Portfolios' returns represent, respectively, 39/7/1 individual portfolios and 68%/27%/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. 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.

ADDITIONAL DISCLOSURE NOTICE

MARTIN CAPITAL ADVISORS, LLP (MCA) is a registered investment advisor based in Austin and San Antonio, Texas, founded in 1989. MCA specializes in managing customized equity and balanced investment portfolios with an all-cap equity strategy to grow capital, as well as balanced strategies to grow capital with less volatility.

MCA claims compliance with the Global Investment Performance Standards (GIPS®). Martin Capital Advisors, LLP has been independently verified for the periods January 1, 1999 to June 30, 2015 by Dabney Investment Consulting Associates, Inc. The verification reports are available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

Returns are shown in U.S. dollars net of fees.

Leverage (margin) is not normally used except temporarily or at client request. Derivatives such as options may be used occasionally as a risk reduction measure.

The GIPS standards allow firms to link non-GIPS-compliant performance to their compliant history provided that no non-compliant performance is shown for periods beginning on or after 1 January 2000. Performance for periods prior to 1/1/1999 is not GIPS-compliant, but has been linked to the subsequent GIPS-compliant performance for cumulative periods.

MCA Flexible Growth Portfolios are invested in publically traded companies with the goal of maximizing long-term returns. These portfolios are classified as an all-cap core strategy, but predominately invest in large and mid-cap stocks, blending the characteristics of both growth and value investing. Each portfolio typically invests in 30 to 40 stocks that are rigorously selected to meet our core philosophy of investing in companies with an enduring competitive advantage that offer growth at a reasonable price. These portfolios are for investors who are willing to accept significant short-term volatility in the pursuit of superior long-term returns. The benchmark for this composite is the S&P 500 Index, which is an index of the 500 leading companies in the U.S. and is designed to reflect the risk and return characteristics of the large-cap U.S. equities universe.

MCA Balanced Portfolios are invested in equities and fixed income securities with a target asset allocation of 75% equities and 25% fixed income. These portfolios are for investors with a long-term investment horizon who seek to grow capital, but want to do so with less short-term volatility than the MCA Flexible Growth Portfolios. The equity investments in the portfolios are classified as an all-cap core strategy and are managed in the same way as the MCA Flexible Growth Portfolios. Fixed income investments include both individual and ETF fixed income securities. The benchmark for this composite is a blend of 75% S&P 500 Index and 25% Barclays U.S. Aggregate Bond Index, rebalanced monthly. The S&P 500 is an index of the 500 leading companies in the U.S. and is designed to reflect the risk and return characteristics of the large-cap U.S. equities universe. The Barclays U.S. Aggregate Bond index is made up of the Barclays U.S. Government/Corporate Bond Index, Mortgage-Back Securities Index, and Asset-Backed Securities Index, and only includes securities that are investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

MCA Conservative Portfolios are invested in equities and fixed income securities with a target asset allocation of 50% equities and 50% fixed income. These portfolios are for investors who prefer to significantly reduce short-term volatility in their investments rather than maximize long-term returns. The equity investments in the portfolios are classified as an all-cap core strategy and are managed in the same way as the MCA Flexible Growth Portfolios. Fixed income investments include both individual and ETF fixed income securities. The benchmark for this composite is a blend of 50% S&P 500 Index and 50% Barclays U.S. Aggregate Bond Index, rebalanced monthly. The S&P 500 is an index of the 500 leading companies in the U.S. and is designed to reflect the risk and return characteristics of the large-cap U.S. equities universe. The Barclays U.S. Aggregate Bond index is made up of the Barclays U.S. Government/Corporate Bond Index, Mortgage-Back Securities Index, and Asset-Backed Securities Index, and only includes securities that are investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

To receive a list of composite descriptions of MCA and/or a compliant presentation, contact Robert Godines at (210) 694-2100, ext. 2, or robert@martincapital.com.