INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Stocks Rebound in Fourth Quarter, then Retest August and September Lows in January

January 25, 2016

The stock market rebounded in the fourth quarter, but still ended the year with mixed results. The S&P 500 advanced slightly, while small cap stocks, as represented by the Russell 2000, fell over 4%, and Warren Buffett’s Berkshire Hathaway, a surrogate for “value” stocks, lost more than 12%. Fixed income returns for 2015 were also mixed as the Barclays Aggregate Bond Index managed a slight 0.5% total return, while energy related income investments were hammered in the wake of lower oil prices. The price of gold declined during the course of the year, despite occasional flights to safety, finishing the year with a 10% loss.

As we enter 2016, stock prices have fallen back into correction territory, retesting the August and September lows, and even some indexes, such as the Russell 2000, are in bear markets (down over 20%) from their highs last summer. Most commentators blame continuing uncertainty in the Chinese markets and further declines in energy prices, but these reasons do not seem to me to have materially negative implications for most of the U.S. economy. Less than 1% of U.S. GDP is tied to the Chinese economy and, more importantly, U.S. companies, such as Apple and Starbucks, say that they have seen no slowdown in their sales in China. Regarding the drop in oil prices, less than 15% of the S&P 500 is made up of energy related companies, so most companies and, of course, consumers, too, actually benefit from lower energy prices.

I believe that renewed uncertainty about how quickly the Federal Reserve may raise rates is the more likely reason for recent turmoil in the equity markets. Going into the Fed Funds rate increase in December the mantra was “one and done” and few could argue that a 0.25% hike was likely to have much impact on the modest economic growth that has occurred over the past six years. However, almost immediately after the rate increase, members of the FOMC (Federal Open Market Committee) began rattling sabers for four more rate hikes in 2016, without much reference to the “data dependency” that had been promised previously. Barring an unexpected surge in economic growth, the stock market has perceived that four more increases in the Fed Funds rate in the next year could be materially negative to the economy and corporate earnings, the lifeblood of stock prices. Fortunately, the same pundits and commentators who supported the December raise are now falling all over themselves to push back on the notion that four more rate increases should be a done deal. My best guess is that this chorus will resound in the ears of the FOMC members and that “data dependency” will once again become the watchword for the Fed, in which case the odds are good that the stock market is in the vicinity of a major market bottom.

COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to December 31, 2015

<table>
<thead>
<tr>
<th>Martin Capital Advisors¹</th>
<th>S&amp;P 500</th>
<th>Wilshire 5000</th>
<th>Barclays Aggregate Bond Index</th>
<th>3 Month T-Bill</th>
<th>Consumer Price Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total²</td>
<td>1461.0%</td>
<td>939.5%</td>
<td>992.5%</td>
<td>344.8%</td>
<td>98.7%</td>
</tr>
<tr>
<td>Avg.³</td>
<td>11.6%</td>
<td>9.8%</td>
<td>10.0%</td>
<td>6.2%</td>
<td>2.8%</td>
</tr>
</tbody>
</table>

¹Total performance, net of commissions, fees, and expenses of all Martin Capital Advisors’ Flexible Growth Portfolios.
²Total compounded return, including reinvestment of dividends and interest.
³1991-2015 annualized return.
Real annualized gross domestic product expanded at a rate of 2.1% in the third quarter, slowing down from the previous quarter, but nevertheless expanding at a much stronger rate than initially forecasted. The weak global economy and uncertainty that it brings is still a major headwind. These forces are creating pressure for areas of the economy related to manufacturing and industrial production; however, pockets of strength continue to underpin the domestic economy and have proven to be remarkably resilient. (Figure 1)

Most notably, the US labor market continues to be the strongest in decades. In December, net new jobs increased by 200,000, and November and October payrolls were revised up by 50,000 jobs. The unemployment rate remained at 5.0% for the third consecutive month. This was due to an increase in the labor participation rate, which is 0.2% higher than the historical bottom it reached in October. The 5% headline unemployment number will likely continue to face resistance from a rising labor participation rate. However, more people entering the workforce should help eliminate slack in labor market, which overtime should exert upward pressure on wages. So far, wage growth has been tepid – in December, hourly wages remained flat, and for the year were 2.5% higher. (Figure 2)

Added weakness internationally and the Fed’s decision to raise interest rates has caused the US dollar to further strengthen, which is having the most immediate impact on U.S. manufacturing. In December, the ISM Manufacturing Index fell to 48.2. This was the second straight month the reading was below 50, which is the threshold that signifies contraction. Despite the struggles in manufacturing, the ISM Services Index continues to be strong and recorded 55.3% in December. The Services Index is a more important indicator of the health of the U.S. economy as services make up a much larger contribution to both GDP and employment.

Housing and construction continue to be sectors of growth. For the month of November, housing starts and permits were up 16.5% and 18.8%, respectively. Construction spending has also been strong and was up 10.5% for the month, and construction jobs were a key contributor to the strong labor report in December. The increase in the number of construction jobs and housing permits provide a leading indication that housing will likely continue to be an area of economic strength in the coming months.

The healthy labor market, lower gas prices, and rising home prices are buoying consumer confidence. The Conference Board reported that consumer confidence rose to 96.5 in December from 92.6. All of these tailwinds are causing a steady increase in retail sales. In November, sales increased 0.2% and are 1.4% higher for the year.

Inflation remains weak and faltering economies in countries like China and Brazil are exerting downward pressure on currencies and commodities, both of which dampen inflation. In the last year, inflation is only up 0.5% and core inflation is up 2.0%. Despite low inflation, the Federal Reserve raised interest rates to between 0.25% and 0.50% after seven years of near zero rates. The Fed cited the strong labor market and confidence that inflation will increase next year as the reason for the hike. The Fed signaled a plan for four quarter-point increases in 2016, however, if inflation does not materialize, the Fed may delay any further rate increases or even reverse course. (Figure 3)

Over the quarter, yields on US Treasuries continued to narrow. At the beginning of the quarter, the 2-year yield was 0.64 basis points and the 10-year fetched 2.05 basis points for a spread of 1.41. By the end of the quarter, the 2-year yield was 1.06 and the 10-year went for 2.27, a spread of 1.21. More recently, yields have tightened even further as the stock market correction has hastened capital flows to Treasuries. This flattening of the yield curve is an important sign to pay attention to, especially as the Fed may continue to increase short-term rates. (Figure 4)

The global macro economy has weighed on the US economy for the last couple years and in a fairly significant way for all of 2015. Despite the pressure, many of the most important sectors of the domestic economy are improving at record pace. As we move into 2016, the question is whether the U.S. economy can remain resilient or if global weakness will eventually hurt its performance. The Fed seems to believe in the former, and so far in 2016, the market appears to be betting on the latter.
### Leading Economic Indicators as of December 2015

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Current Reading</th>
<th>1-month change</th>
<th>6-month change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conference Board Leading Economic Index</td>
<td>123.7</td>
<td>-0.1%</td>
<td>+0.6%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>2054</td>
<td>-1.2%</td>
<td>-2.1%</td>
</tr>
<tr>
<td>Average weekly hours, manufacturing</td>
<td>41.7</td>
<td>unch</td>
<td>-0.1</td>
</tr>
<tr>
<td>Initial Jobless Claims</td>
<td>275.6K</td>
<td>+6.2K</td>
<td>+0.6K</td>
</tr>
<tr>
<td>Manufacturers’ new orders, capital goods ex. aircraft</td>
<td>41.3B</td>
<td>+0.3%</td>
<td>+1.5%</td>
</tr>
<tr>
<td>Manufacturers’ new orders, consumer goods and materials</td>
<td>139.5B</td>
<td>+0.1%</td>
<td>+2.4%</td>
</tr>
<tr>
<td>ISM New Orders</td>
<td>49.2</td>
<td>+0.3</td>
<td>-6.8</td>
</tr>
<tr>
<td>Building Permits</td>
<td>1232K</td>
<td>-3.9%</td>
<td>-7.9%</td>
</tr>
<tr>
<td>Spread between 10-yr Treasury Note and Federal Funds Rate</td>
<td>2.00</td>
<td>-0.14</td>
<td>-0.23</td>
</tr>
<tr>
<td>Avg. Consumer Expectations for Business Conditions</td>
<td>-0.10</td>
<td>-0.12</td>
<td>-0.61</td>
</tr>
<tr>
<td>Leading Credit Index (negative readings are positive for the LEI)</td>
<td>-0.62</td>
<td>+0.31</td>
<td>-0.09</td>
</tr>
</tbody>
</table>

### Economic Charts as of December 31, 2015

- **Figure 1**: Real Annualized GDP
- **Figure 2**: Unemployment Rate
- **Figure 3**: 12-mo % change in CPI and Core CPI
- **Figure 4**: Yield Curve
INVESTMENT RESULTS
Martin Capital Advisors’ Investment Portfolios vs. S&P 500 and Barclays Aggregate Bond Indexes

MCA FLEXIBLE GROWTH PORTFOLIOS TOP 20 STOCKS as of December 31, 2015


RELATIVE LONG-TERM PERFORMANCE January 1, 1991 to December 31, 2015

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 12/31/2015, the MCA Flexible Growth/Balanced/Conservative portfolios’ returns represent, respectively, 40/8/1 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). The GIPS standards permit non-compliant returns prior to 1/1/2000 to be presented with and linked to compliant returns post 1/1/2000. MCA performance for periods prior to 1/1/1999 is not yet GIPS-compliant, but has been linked to the subsequent GIPS-compliant performance for cumulative periods. MCA has been independently verified for the periods January 1, 1999 to September 30, 2015 by Dabney Investment Consulting Associates, Inc. The verification reports are available upon request. 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*).

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.

Martin Capital Advisors, LLP has been independently verified for the periods January 1, 1999 to September 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.

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.