THE COMPASS

July 2016

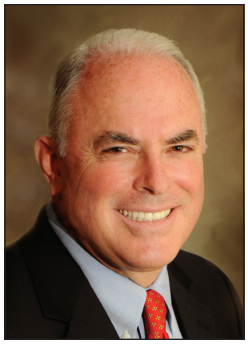
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Stocks Appear Poised for Better Returns After a Volatile First Half of the Year

July 25, 2016

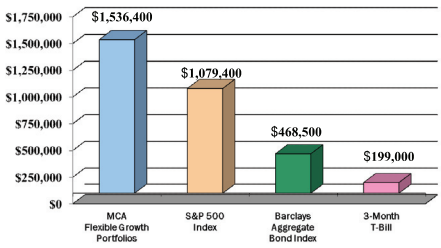
Following U.S. Federal Reserve driven volatility at the beginning of the first quarter, the British vote to exit the EU (Brexit) driven volatility came at the end of the second quarter; however, most stock indices still managed to finish the first half of the year with mixed to slightly positive results. Bonds and gold continued to benefit from the uncertainties weighing on stocks as U.S. Treasury rates fell to record lows and gold bounced back above early 2015 prices in a counter-trend move against its long-term decline.



As we enter the third quarter, stocks have maintained a strong rally off of their Brexit lows, while bonds and gold have begun to roll over from their recent highs. Although Brexit shocked the global markets and there is still uncertainty about what the consequences may be, I stand by what I said in an email to clients at the lows of two days of post-Brexit selling on June 27: *I do not believe that Brexit will ultimately have any material impact on the global economy or the earnings of most companies, so I expect that the current selling will likely turn into a buying opportunity sooner than later.*

In fact, I think that if I am wrong and Brexit does have a material impact on the global economy and corporate earnings, it actually could be beneficial, insofar as it has shifted the Fed and global monetary policies into a more accommodative mode.

Admittedly, short-term timing is always a difficult game to play, but it seems that my statements in the April edition of *The Compass* that there are *signs that there could be a significant improvement in GDP and earnings in the latter half of the year...* and *the odds continue to favor higher stock prices this year* may prove to be prescient. Right now, second quarter GDP, which will be reported at the end of the month, is on track for about a 2.5% growth rate, which would be quite a bit better than the first quarter's anemic 1.1% rate, and most economists are anticipating the rebound in growth to last for at least several more quarters. Also, corporate earnings reports have gotten off to a good start this month and seem to be confirming that a turnaround is in the works. Many investors today are not well positioned to take advantage of the potentially positive impact of better growth and earnings, so as they adjust to a more favorable outlook, stock prices should react favorably as the year progresses. The main risk to this scenario is that the Fed returns to a rate raising regimen that once again unnerves the markets, but Brexit, the presidential election, and a host of other variables will likely keep them on hold for the time being.



See details and important Disclosure Notice on last page.

COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to June 30, 2016

	Martin Capital Advisors[1]	S&P 500	Russell 3000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
Total[2]	1436.4%	979.4%	1031.3%	368.5%	99.0%	80.1%
Avg.[3]	11.3%	9.8%	10.0%	6.2%	2.7%	2.3%

[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]1991-2016 annualized return.

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

Real annualized gross domestic product expanded at a rate of 1.1% in the first quarter of 2016. While this was a slowdown from the previous quarter, it was much higher than initial forecasts. GDP is expected to rebound for the rest of the year, with estimates for the second quarter hovering around 2.5%. **(Figure 1)**

After a weak report in May, in which the economy only added 11K jobs, the labor market rebounded impressively in June, adding 287K jobs compared to expectations for 175K. Average hourly earnings ticked up 0.1% and are 2.6% higher than a year ago – the best annual improvement since the Great Recession. Even with the strong jobs number, the unemployment rate edged up slightly to 4.9% as nearly 0.5 million workers entered the labor force. There still remains considerable slack in the labor market. The Labor Department U-6 figure, which is the total number of unemployed plus those who are "marginally attached" to the labor force, reached an all-time post-recession low in June of 9.6%, but is still a full percentage point higher than what is considered full employment. **(Figure 2)**

The Brexit vote reignited the rally in the dollar that started in late 2014. The strengthening of the dollar will likely hurt US exporters, manufacturers, and multinationals. Already through the first five months of the year, US exports have declined 5% relative to a year ago. Despite the external pressures, the ISM Manufacturing Index has been surprisingly resilient. The Index rose to 53.2 in June, which was the highest level since February 2015. However, this was before the Brexit vote. The ISM Services Index has also been strong, rising to 56.5 in June from 52.9 the month before, and reaching the highest level in seven months.

Consumers' feelings towards the economy and their spending habits continue to be healthy. Consumer Confidence rose to 98.0 in June from 92.4 in May, and this confidence is translating into sales. Despite a challenging environment for brick-and-mortar retailers, US retail sales grew 0.5% in May and 1.3% in April, and are being aided by increases in online spending and higher gas prices.

The housing market remains a stalwart source of resiliency for the US economy. Sales of existing homes increased to 5.5 million in May, which was the strongest pace since 2007. Sales of new homes hit a post-recession high of 619K in April and only dipped slightly in May. Home prices continue to steadily increase at an annual rate of 5%, just as they have since early 2015. Additionally, Brexit should cause mortgage rates to fall, which will provide continued support for the housing market.

Inflation has shown some signs of taking hold. Both the CPI and Core CPI increased 0.2% in June, marking the fourth straight increase. On a yearly basis, CPI is 1% higher, while Core CPI is 2.3% higher. Low inflation and rising hourly wages have caused an increase in consumer purchasing power, which bodes well for continued health in consumer spending. **(Figure 3)**

The Brexit vote has caused a flight to safety as investors are fleeing the British pound and other assets to buy currencies like the dollar and yen as well as US bonds. This has sent yields on long-term Treasuries lower, causing a further flattening of the yield curve. As of June 30, 2016, the 10-year Treasury yielded 1.49% compared to 2.35% a year ago, and the spread between the 2-year and the 10-year Treasury was 91 basis points compared to 171 basis points in the prior year. **(Figure 4)**

The flattening of the yield curve remains a point of caution that bears watching. The US economy is showing signs of strength, while at the same time investors are fleeing to safe assets. If economic activity picks up in the latter half of the year, the Fed may be more inclined to increase the Fed Funds rate, which could potentially cause a yield curve inversion that could weaken the economy next year. So far though, the Fed has continued to err on the side of caution, and there remains enough slack in the labor force and reasons to be cautious that the Fed will likely remain accommodative for the time being.

ECONOMIC CHARTS

as of June 30, 2016

Figure 1

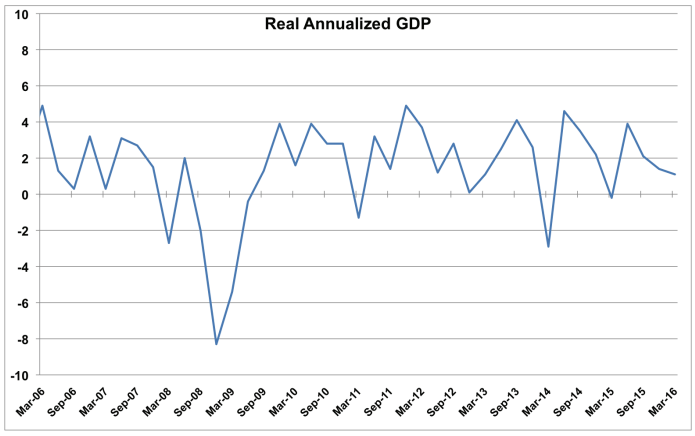


Figure 3

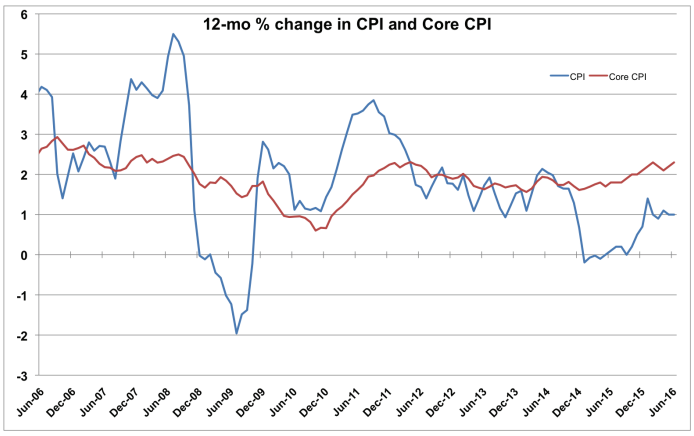


Figure 2

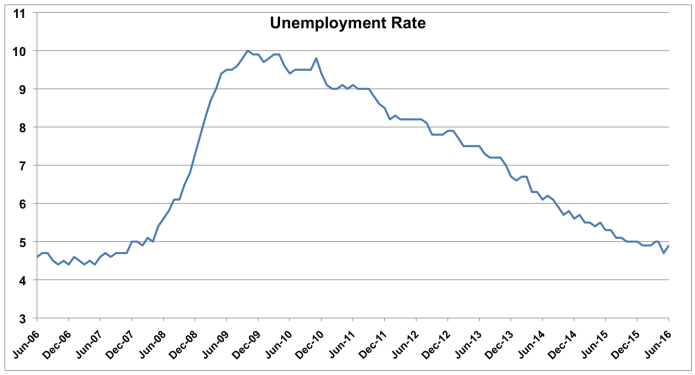
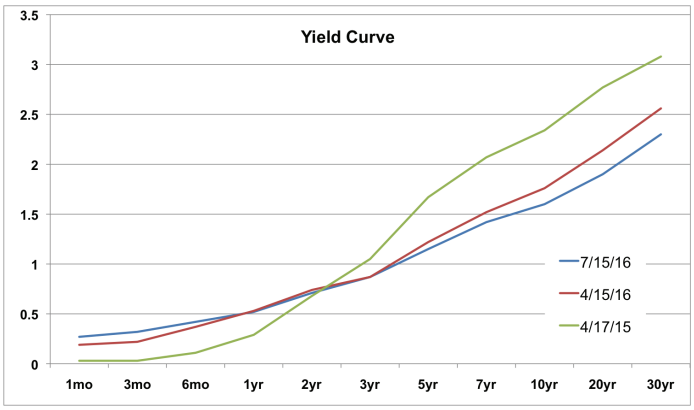


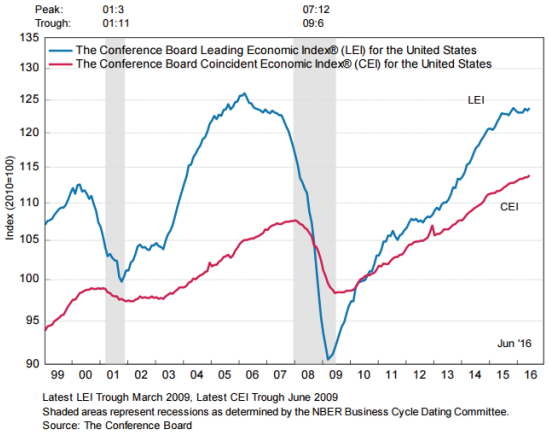
Figure 4



LEADING ECONOMIC INDICATORS

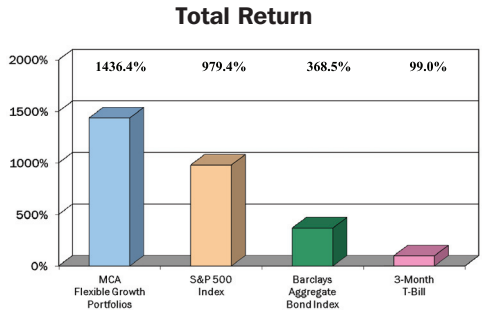
as of June 2016

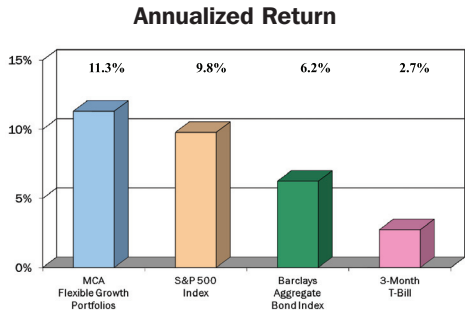
	Current Reading	1-month change	6-month change
Conference Board Leading Economic Index	123.7	+0.3%	+0.3%
S&P 500	2084	+0.9%	+1.5%
Average weekly hours, manufacturing	41.7	-0.1	unch
Initial Jobless Claims	264.8K	-12.1K	-11.7K
Manufacturers' new orders, capital goods ex. aircraft	37.1B	+0.7%	-0.2%
Manufacturers' new orders, consumer goods and materials	139.0B	+0.2%	-2.2%
ISM New Orders	57.0	+1.3	+8.2
Building Permits	1153K	+1.5%	-4.0%
Spread between 10-yr Treasury Note and Federal Funds Rate	1.26	-0.18	-0.74
Avg. Consumer Expectations for Business Conditions	-0.02	+0.08	+0.11
Leading Credit Index (negative readings are positive for the LEI)	-0.63	-0.37	-0.58



RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to June 30, 2016





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MARTIN CAPITAL ADVISORS, LLP

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

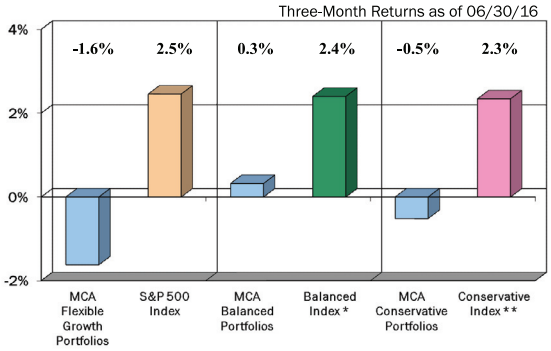
MCA FLEXIBLE GROWTH PORTFOLIOS TOP 20 STOCKS

as of June 30, 2016

1	Apple	95.60	6	Oracle	40.93	11	Diamond Hill Inv. Group	188.42	16	Blackrock	342.53
2	Starbucks	57.12	7	Texas Instruments	62.65	12	Tractor Supply	91.18	17	IPG Photonics	80.00
3	Intuitive Surgical	661.41	8	MasterCard	88.06	13	Visa	74.17	18	Tiffany	60.64
4	Whole Foods Market	32.02	9	Charles Schwab	25.31	14	Alphabet Cl A	703.53	19	ARM Holdings	45.51
5	DaVita	77.32	10	Williams-Sonoma	52.13	15	Costco Wholesale	157.04	20	Cisco Systems	28.69

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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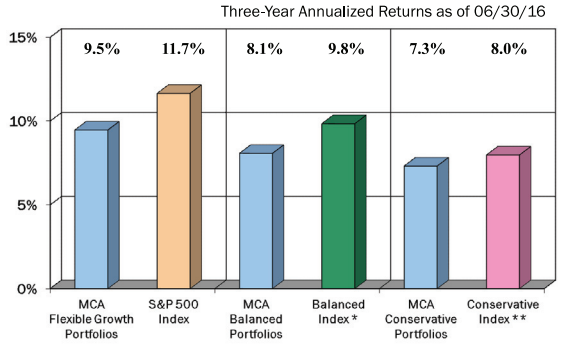

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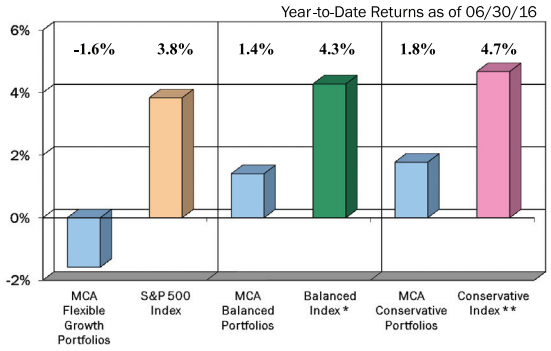

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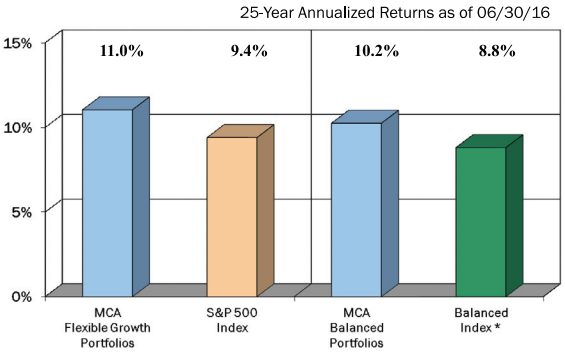

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IMPORTANT DISCLOSURE NOTICE

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 06/30/2016, the *MCA Flexible Growth/Balanced/Conservative* portfolios' returns represent, respectively, 39/8/1 individual portfolios and 66%/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 March 31, 2016 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 March 31, 2016 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.