THE COMPASS

October 2016

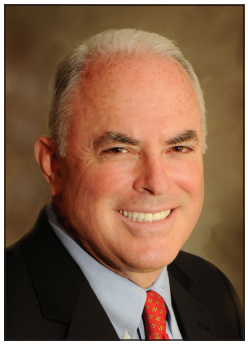
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Following Strong Third Quarter Stock Market Returns, All Eyes are on the Fed

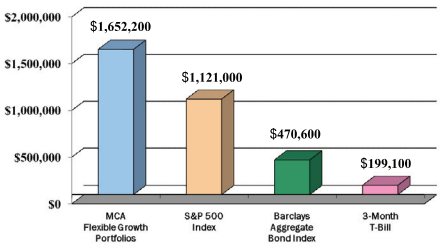
October 26, 2016

Strong third quarter stock market returns were driven by expectations for a rebound in earnings growth and the Fed remaining data dependent. The down trend in earnings appears to have bottomed in the third quarter and revenues for the holiday season are projected to be better than average. Also, most analysts are forecasting double digit earnings growth next year. Fixed income returns were stable during the quarter as there is still some uncertainty about the potential for higher growth and inflation. After a significant countertrend rally through the first half of the year, gold fell back in the third quarter and appears to be in the process of resuming the bear market that began in 2011. The price of oil (WTI) retested $40 per barrel and now is fluctuating around $50 per barrel and showing signs that supply and demand may be starting to equalize.



Stocks have pulled back slightly at this point in the fourth quarter in what looks like a normal backing and filling process of building a base for the next rally. However, uncertainty about the Fed's next interest rate increase, which could come before the end of the year, may continue to weigh on stocks, so the likelihood of another rally by the end of the year is somewhat in question. While fixed income investments remain extremely overvalued, they could become even more expensive in reaction to another Fed Funds rate increase, which would most likely drive long rates down and prices up. This happened when the Fed Funds rate was increased by .25% last December and the ten-year Treasury rate then fell 100 basis point in less than two months.

Every recession since at least the 1950s has been preceded by the Fed raising the Fed Funds rate to a point at which the ten-year Treasury yield falls below the one-year Treasury yield, inverting the yield curve from the normal curve in which long rates are higher than short rates. The economy then contracts as banks cut back on lending because their cost of borrowing from their customers' money market and savings accounts is higher than the rates they can charge for mortgages and long-term loans. That said, with the rate on the ten-year Treasury now at about 1.8%, a .25% Fed Funds rate hike will not invert the yield curve, so the possibility of a recession in the near future is unlikely. As earnings begin to pick up in the fourth quarter, the stock market probably will continue to work its way higher.



See details and important Disclosure Notice on last page.

COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to September 30, 2016

	Martin Capital Advisors[1]	S&P 500	Russell 3000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
Total[2]	1552.2%	1021.0%	1081.0%	370.6%	99.1%	80.0%
Avg.[3]	11.5%	9.8%	10.1%	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 1.2% in the second quarter. This was a disappointment in comparison to expectations. The weaker than expected result was caused by reduced business investment and lower government spending. Consumer spending continues to be healthy, as exemplified by the 4.2% growth in the personal consumption component. For the year, economic growth is tracking at around 1%, down from the 2.1% average since the recession ended. **(Figure 1)**

The labor market slowed slightly in September with 156,000 non-farm payroll jobs being added. The average for the last three months has been 192,000. The unemployment rate has ticked up to 5.0% due to a higher labor force participation rate, which is now 62.9%. Average hourly wages were up 2.6% and are continuing to outpace inflation. **(Figure 2)**

The strong dollar and weak international demand continue to impact manufacturing. The ISM Manufacturing Index fell to 50.2, a two year low. The index hasn't dipped below 50 since 2013. The ISM Services component is also slipping, yet remains in healthy territory. In September the index fell to 56.9 from 59.0 in August and 60.3 in July. The Services Index tends to track retail sales, which have been expanding as a result of strong consumer spending.

Consumer Confidence increased to 104.1 in September, the highest level since August 2007. Meanwhile, the University of Michigan Consumer Sentiment Index is moving in the opposite direction. The preliminary Sentiment Index reading for October was 87.9, which is the lowest level in a year. While both indices survey consumers' feelings about the economy, the primary difference is the Sentiment Index tends to incorporate more attitudes about personal financial conditions, while Consumer Confidence focuses on general economic conditions.

The strong gains in employment over the past two years and low interest rates should continue to spur the housing market. However, lately the housing market has become a victim of its own success. Strong demand coupled with limited inventory has caused a surge in prices over the past few years. Prices are now back to their 2006 peak, which is making it difficult for first time home buyers to enter the market. As a result, home sales are being limited. Existing home sales fell 0.9% last month, marking the second straight month of decline. New home sales also decreased, but are still 20.6% above last year. One way to help slow the surge in prices is more construction. Unfortunately, building permits fell 0.4% and building starts fell 5.8% last month, and new housing construction continues to remain below the long-term annual average.

Inflation continues to be weak, which is why the Fed has remained so accommodative. The Consumer Price Index increased 0.3% in September and is 1.5% higher compared to a year ago. The Core Index increased 0.1% and is 2.2% higher for the year. The Producer Price Index, which measures the prices U.S. companies receive for their goods and services, increased 0.3% and is 0.7% higher than a year ago. **(Figure 3)**

As expectations in the likelihood of a rate hike have been delayed, interest rates have risen. The 10-year is now fetching 1.80% and the two-year 0.84% compared to 1.49% and 0.58% three months ago. The yield curve is still relatively flat with the spread between the 10-year and 2-year still less than 100 basis points. A year ago the spread was 1.43 basis points. When the Fed does raise rates, it will be important to see if long-term rates also increase, since any further flattening in the yield curve provides a reason to be cautious. **(Figure 4)**

Growth in 2016 so far has been anemic. The recovery is now in its seventh year and is being propelled by the consumer. One positive in slow growth is that it's sustainable, which is one reason why this recovery is the fourth longest on record. The fundamentals of a strong labor and housing market are giving the consumer confidence and this is turning into spending, which should continue to propel the economy forward. However, there is a tipping point to how much consumer spending can continue to buoy the economy since household incomes adjusted for inflation are still below pre-recession levels. As we put the election cycle behind us, we will see just how confident consumers are in the economy by their appetite for holiday shopping.

ECONOMIC CHARTS

as of September 30, 2016

Figure 1

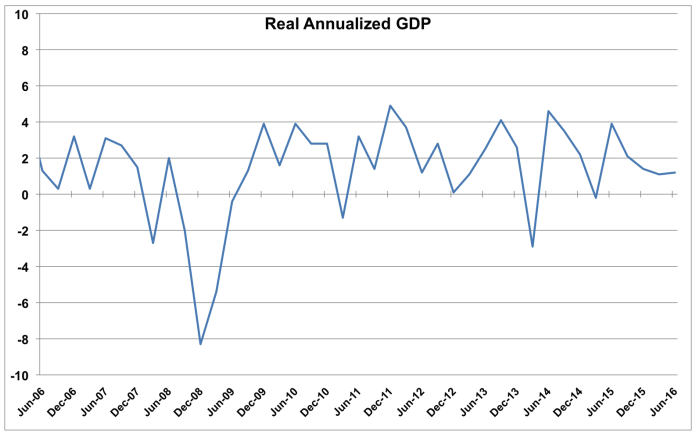


Figure 3

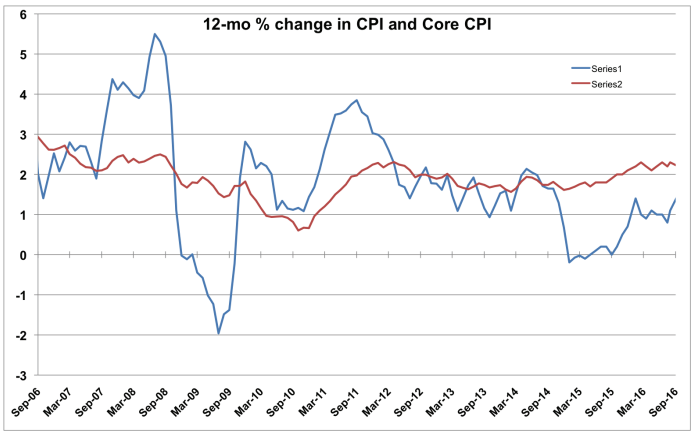


Figure 2

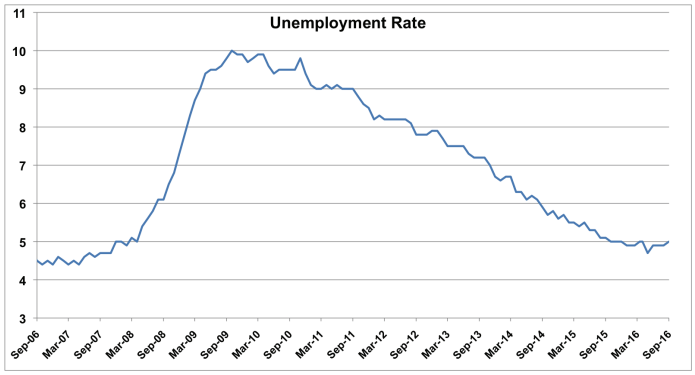
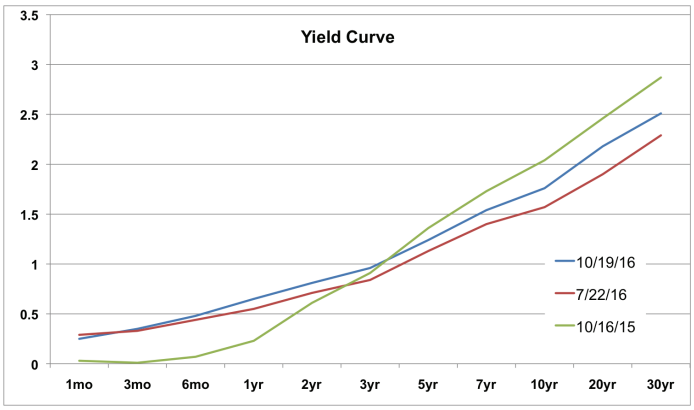


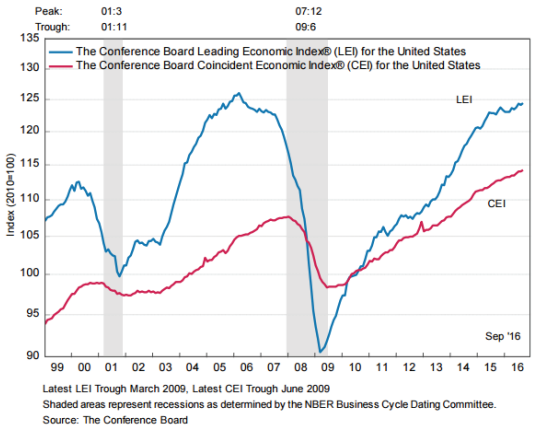
Figure 4



LEADING ECONOMIC INDICATORS

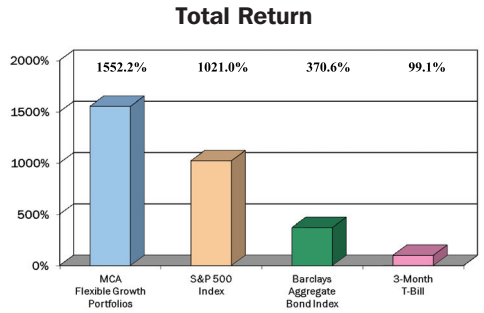
as of September 2016

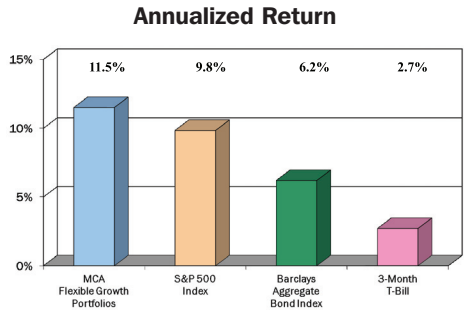
	Current Reading	1-month change	6-month change
Conference Board Leading Economic Index	124.4	+0.2%	+1.4%
S&P 500	2157	-0.9%	+6.3%
Average weekly hours, manufacturing	41.7	-0.1	unch
Initial Jobless Claims	252.8K	-10.5K	-14K
Manufacturers' new orders, capital goods ex. aircraft	37.4B	-0.3%	+0.1%
Manufacturers' new orders, consumer goods and materials	139.0B	+0.1%	-0.8%
ISM New Orders	55.1	+6.0	-3.2
Building Permits	1225K	+6.0%	+12.1%
Spread between 10-yr Treasury Note and Federal Funds Rate	1.23	+0.07	-0.30
Avg. Consumer Expectations for Business Conditions	0.07	+0.17	+0.11
Leading Credit Index (negative readings are positive for the LEI)	0.15	+0.17	+0.65



RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to September 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.

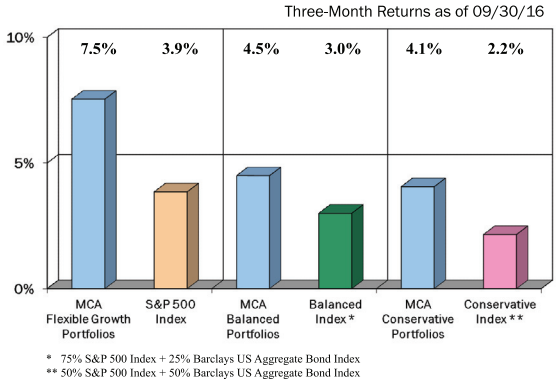
MCA FLEXIBLE GROWTH PORTFOLIOS TOP 20 STOCKS

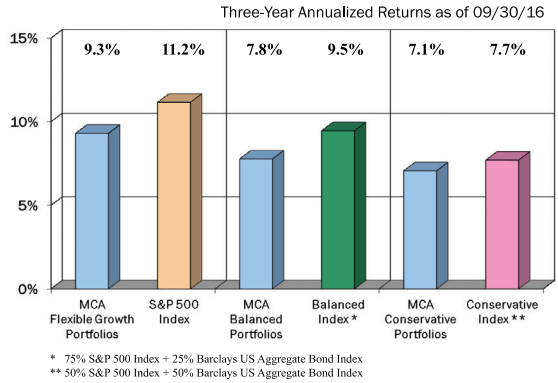
as of September 30, 2016

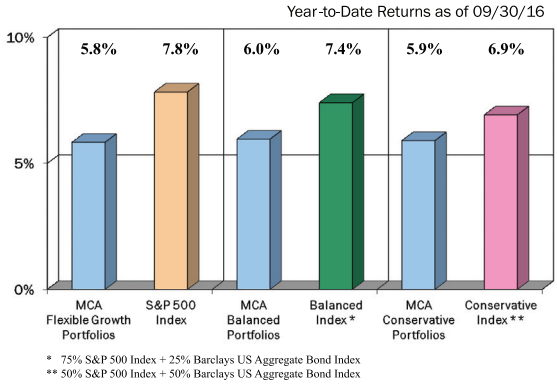
1	Apple	113.05	6	Texas Instruments	70.18	11	Visa	82.70	16	Tractor Supply	67.35
2	Starbucks	54.14	7	MasterCard	101.77	12	Williams-Sonoma	51.08	17	IDEXX Laboratories	112.73
3	Intuitive Surgical	724.83	8	Edwards Lifesciences	120.56	13	Diamond Hill Inv. Group	184.79	18	Costco Wholesale	152.51
4	Whole Foods Market	28.35	9	Oracle	39.28	14	Alphabet Cl A	804.06	19	Blackrock	362.46
5	Charles Schwab	31.57	10	DaVita	66.07	15	Tiffany	72.63	20	IPG Photonics	82.35

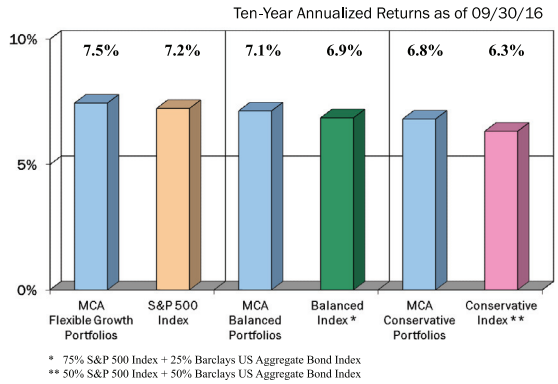
INVESTMENT RESULTS

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 09/30/2016, the *MCA Flexible Growth/Balanced/Conservative* portfolios' returns represent, respectively, 41/8/1 individual portfolios and 67%/26%/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 June 30, 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 June 30, 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.