

THE COMPASS

April 2017

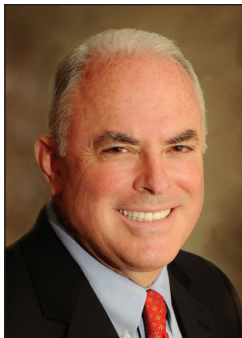
A Quarterly Newsletter of Martin Capital Advisors, LLP

INVESTMENT PERSPECTIVE by Paul Martin, Managing Partner

Improving Corporate Earnings Drive Stocks Higher in First Quarter

April 24, 2017

This quarter I could pretty much just repeat what I said about the stock market in the last edition of *The Compass* in January. Anyway, I'll give it another run: As corporate earnings have continued to improve, stocks have continued to rally with just over a 6% return for the S&P 500 in the first quarter. The Barclays Aggregate Bond Index achieved a slightly positive return for the quarter as the Fed raised rates again in March and long-term yields began to reverse their upward trend in anticipation of the Fed becoming less accommodative. Gold recovered some losses from the latter half of last year, staying in the trading range that it has been in since the end of 2013. WTI crude oil prices remained fairly stable in the \$50 range as the supply and demand balances

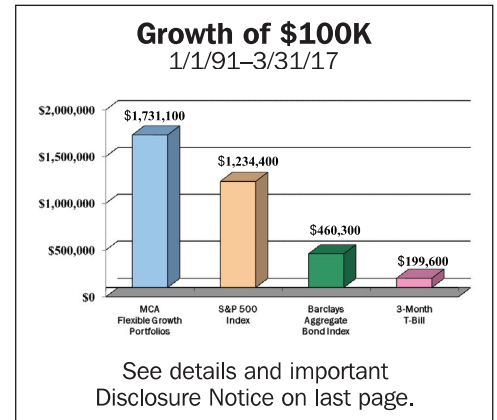


that have been discussed in previous newsletters have remained in place.

Stocks have gotten off to a sluggish start for the second quarter as first quarter gains are being digested, but strength in corporate earnings should

eventually translate into higher stock prices. On the fixed income side, the probability that bonds may also perform well this year is growing as the Fed appears to be entering a period of increasing the Fed Funds rate at a faster clip—which could cause long-term yields to fall in anticipation that a less accommodative Fed will weaken the economy at some point, resulting in lower inflation. For the time being, the improving global economy should allow gold and oil to remain in their trading ranges, but they also eventually will be affected by higher Fed Funds rates.

I remain cautiously bullish on stocks for this year, but as the Fed



raises rates I will become less sanguine. As I have mentioned before, the Fed has driven the economy into every recession since at least the 1950s by driving the Fed Funds rate up so much that short rates become higher than long rates, resulting in a “yield curve inversion.” We are still some distance from an inversion, and the earliest a recession has ever happened is six months after the curve has inverted, so there probably is still plenty of upside potential for stocks. However, as we draw closer to an inversion, I will begin reaching out to our clients to discuss index option hedging strategies. Until then stock prices should have a bias to go higher for at least the rest of the year.

COMPARISON OF INVESTMENT RESULTS

January 1, 1991 to March 31, 2017

	Martin Capital Advisors ¹	S&P 500	Russell 3000	Barclays Aggregate Bond Index	3 Month T-Bill	Consumer Price Index
Total ²	1631.1%	1134.4%	1201.4%	360.3%	99.6%	82.1%
Avg. ³	11.5%	10.0%	10.3%	6.0%	2.7%	2.3%

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. ³1991-2017 annualized return.

— See Important Disclosure Notice on last page. —

Real annualized gross domestic product (GDP) expanded at a rate of 2.1% in the fourth quarter, contracting from 3.5% growth recorded in the third quarter. The slowdown was thought to be driven by pre-election anxiety, however, it appears to have accelerated into 2017. While preliminary results for first quarter GDP have yet to be released, economists currently project growth to be 1%, which would mark the weakest quarter since 2013. Throughout the economy, there continues to be a disconnect between expectations and actual performance. **(Figure 1)**



The labor market continues to edge towards full employment. The unemployment rate fell to 4.5% from 4.7% in March, despite only adding a disappointing 98,000 jobs. While the number of jobs added was weaker than expected, this was more likely an aberration caused by cold weather than it was due to structural changes in the demand for employment. The labor market remains strong, and as the economy reaches full employment, it is to be expected that the monthly number of jobs added will not be as robust as they once were. Wage growth is now a more important indicator for assessing the health of the economy. To that end, average hourly earnings increased 0.2% in March and are 2.7% higher for the year. This is encouraging, and wages are certainly outpacing inflation, but the appreciation is still shy of the 3.0-3.5% wage growth that is normal for a healthy economy. **(Figure 2)**

Manufacturing continues to improve. The ISM Manufacturing Index was 57.2 in March, dipping down slightly from 57.7 in February, which was the highest reading in three years. Strong export orders are driving the improvement in manufacturing, and this may continue as the dollar has weakened recently. Services are trending in the opposite direction, but nevertheless continue to expand. The ISM Services Index slowed to 55.2 in March, down from 57 in February. This was the slowest services growth in six months.

Consumers continue to be extremely optimistic about the economy, but their feelings are not manifesting into behaviors, and this is hindering the economy. The preliminary report from the University of Michigan showed Consumer Sentiment rose to 98 in April, which is the highest reading since 2000. However, this optimism is not translating into sales. Retail sales fell 0.2% in March, marking the first back to back sales declines in two years. While this gives reason to be concerned, the decline is being blamed on the strong winter storm that impacted the North East and the delay in tax refund checks.

As has been the case for a while, the housing sector remains strong. New home sales jumped 6.1% in February to an annual rate of 592,000. The increase in mortgage rates and higher home prices have not had a negative effect on sales. Rising prices may potentially price out first-time home buyers, however, the wealth effect on existing home owners from rising prices more than offsets any potentially negative impact caused by the loss of first-time buyers. Sales of previously owned homes fell 3.7% in February, but they are not as meaningful of an economic indicator as new home sales. Building permits remain strong, which suggest there are no signs of a near-term slowdown for the housing market.

Inflation continues to be weak, and after showing signs of firming late last year, is now softening again. In March, the Consumer Price index fell -0.3% with the Core index falling -0.1%. This was the first time that the Core index had fallen since 2010. With weak inflation and rising wages, the purchasing power of consumers has increased, which bodes well for future economic growth. **(Figure 3)**

The recent slew of weaker than expected economic data and delays in expectations around any benefit that the economy may receive from tax reform and fiscal stimulus has caused bond yields to contract. The 10-year Treasury had risen from 1.86% before the election to 2.62% on March 13. Since reaching the high, yields have fallen dramatically, and today the 10-year is trading around 2.20%. With falling long-term rates and expectations for more rate hikes this year, the spread between the 2-year and 10-year has contracted to around 100 basis points, from as high as 140 basis points on March 13. **(Figure 4)**

Given the optimism in the economy and in the markets, the question is whether performance will rise to expectations or will expectations be readjusted to more muted growth. The fundamentals of a strong housing market and steadily improving job market continue to underpin the economy. The hope was that changes in fiscal policy and tax policy could turbo charge the economy. The political realities of implementing change are beginning to set in, and the economy is not growing at the rate that many were expecting. However, irrespective of the timing of policy changes, optimistic consumers, steady job growth, rising incomes, growing savings accounts, and low inflation create an environment for strong consumer spending that should support economic expansion for the foreseeable future.

Figure 1

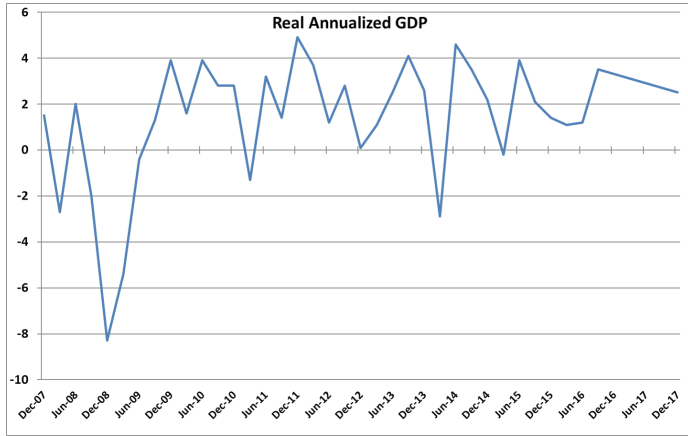


Figure 3

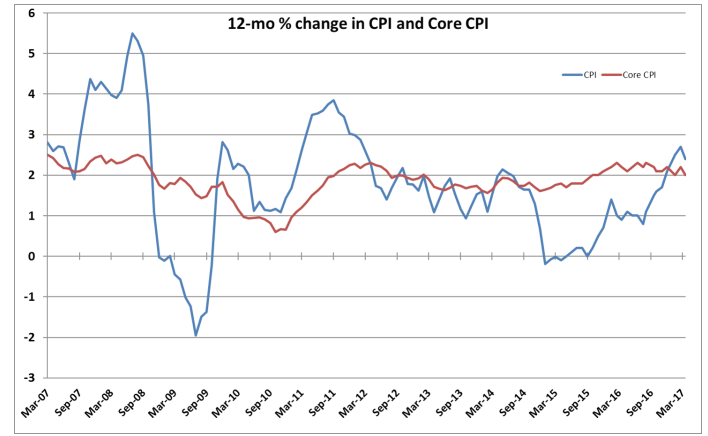


Figure 2

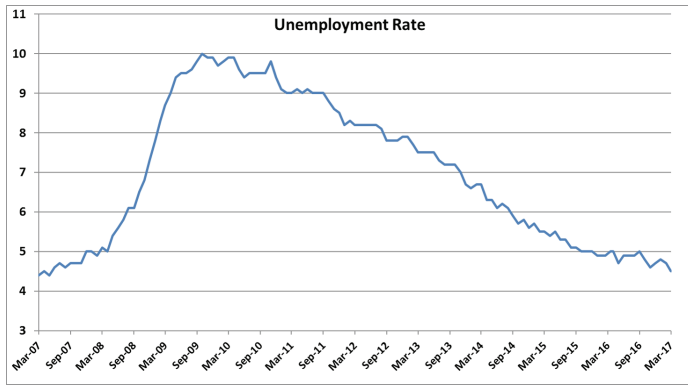
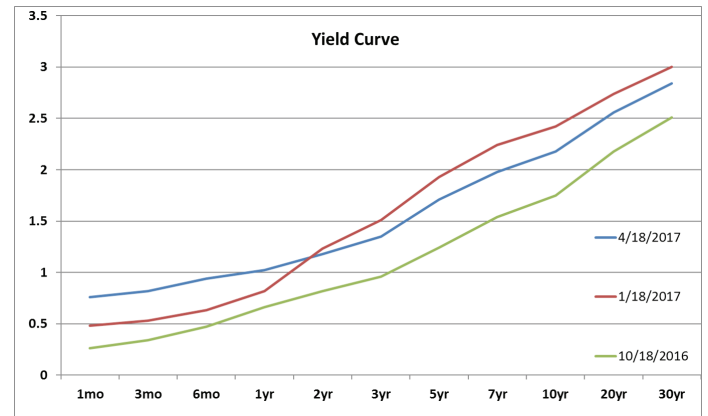
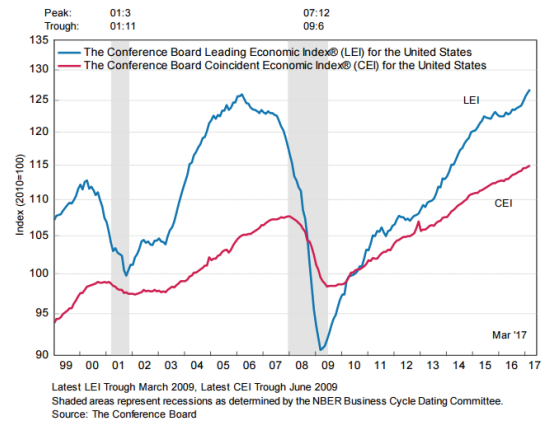


Figure 4



LEADING ECONOMIC INDICATORS

	Current Reading	1-month change	6-month change
Conference Board Leading Economic Index	126.7	+0.5%	+2.4%
S&P 500	2366	+1.6%	+9.7%
Average weekly hours, manufacturing	41.8	-0.2	unch
Initial Jobless Claims	250.2K	+6.8K	-2.6K
Manufacturers' new orders, capital goods ex. aircraft	38.2B	+0.3%	+3.2%
Manufacturers' new orders, consumer goods and materials	140.4B	+0.1%	+1.4%
ISM New Orders	64.5	-0.6	+9.5
Building Permits	1260K	+3.6%	+2.9%
Spread between 10-yr Treasury Note and Federal Funds Rate	1.69	-0.07	-0.30
Avg. Consumer Expectations for Business Conditions	0.85	+0.34	+0.81
Leading Credit Index (negative readings are positive for the LEI)	-0.34	-0.11	+0.08



RELATIVE LONG-TERM PERFORMANCE

January 1, 1991 to March 31, 2017



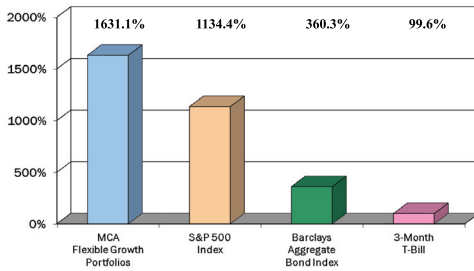
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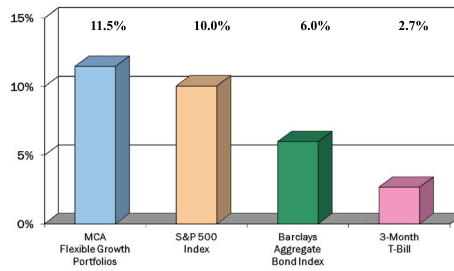
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Martin Capital Advisors, LLP, is a registered investment advisor managing private and institutional investment portfolios.

Total Return



Annualized Return



MCA FLEXIBLE GROWTH PORTFOLIOS TOP 20 STOCKS

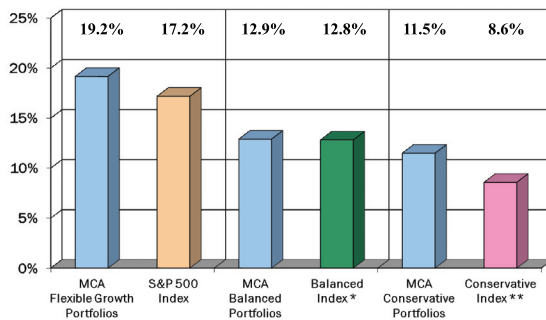
as of March 31, 2017

1 Apple	143.66	6 IDEXX Laboratories	154.61	11 IPG Photonics	120.70	16 Costco Wholesale	167.69
2 Starbucks	58.39	7 Edwards Lifesciences	94.07	12 US Physical Therapy	65.30	17 Toll Brothers	36.11
3 Intuitive Surgical	766.47	8 Whole Foods Market	29.72	13 Visa	88.87	18 Tractor Supply	68.97
4 MasterCard	112.47	9 Texas Instruments	80.56	14 Oracle	44.61	19 Tiffany	95.30
5 Charles Schwab	40.81	10 DaVita	67.97	15 Blackrock	383.51	20 Williams-Sonoma	53.62

INVESTMENT RESULTS

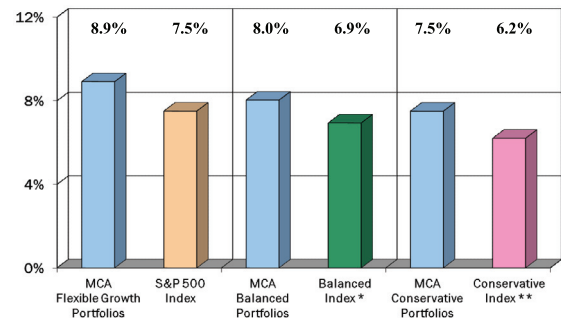
Martin Capital Advisors' Investment Portfolios vs. S&P 500 and Barclays Aggregate Bond Indexes

One-Year Returns as of 03/31/17



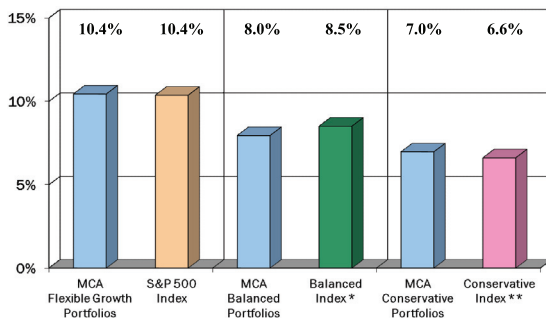
* 75% S&P 500 Index + 25% Barclays US Aggregate Bond Index
** 50% S&P 500 Index + 50% Barclays US Aggregate Bond Index

Ten-Year Annualized Returns as of 03/31/17



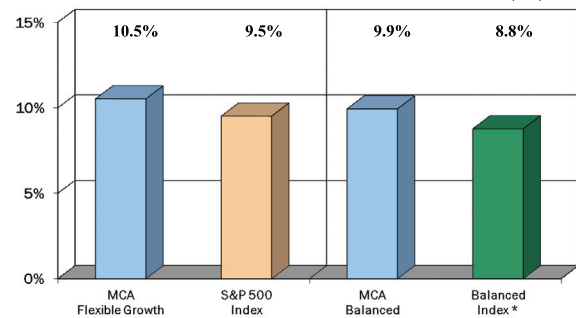
* 75% S&P 500 Index + 25% Barclays US Aggregate Bond Index
** 50% S&P 500 Index + 50% Barclays US Aggregate Bond Index

Three-Year Annualized Returns as of 03/31/17



* 75% S&P 500 Index + 25% Barclays US Aggregate Bond Index
** 50% S&P 500 Index + 50% Barclays US Aggregate Bond Index

25-Year Annualized Returns as of 03/31/17



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

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 03/31/2017, the MCA Flexible Growth/Balanced/Conservative portfolios' returns represent, respectively, 35/6/1 individual portfolios and 71%/23%/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). MCA has been independently verified for the periods January 1, 1991 to December 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 Paul Martin at (210) 694-2100, ext. 1, or paul@martincapital.com.

ADDITIONAL DISCLOSURE NOTICE

MARTIN CAPITAL ADVISORS, LLP (MCA) is a registered investment advisor based in 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.

Martin Capital Advisors, LLP has been independently verified for the periods January 1, 1991 to March 31, 2017 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 publicly 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 Paul Martin at (210) 694-2100, ext. 1, or paul@martincapital.com.