GIA PARTNERS

1st Quarter 2017

Highlights

- In contrast to Washington, markets were quiet during the quarter. Driven by optimism over policy, equities did well, interest rates were flat, credit markets outperformed and our portfolios benefited;
- Economic data softened, but the outlook remains positive for growth. The Fed raised rates preemptively in March, but the move was taken in stride by the markets;
- The March unemployment rate came in a 4.5%. The labor market has tightened and may improve further if the authorities can deliver on their tax and deregulation policies.

Markets

		Returns (%)	
GIA*	Average Quality	1Q17	12 Months
Core Plus Composite	(A)	1.70	4.81
Global Credit Plus Composite	(BBB+)	2.02	6.15
Global High Yield Composite	(BB-)	3.21	19.91
Emerging Market Debt Composite	(BB+)	3.61	11.55

**Returns are net of fees*

Benchmark Bonds			
Bloomberg Barclay's U.S. Agg. Index	(AA+)	0.82	0.44
Treasury	(AAA)	0.67	-1.44
Credit	(A)	1.30	2.96
Mortgage	(AAA)	0.47	0.17
Government/Credit	(AA)	0.96	0.54
BoA Merrill U.S. Corps & Yankees	(A)	1.45	3.06
BoA Merrill Corporate Master	(A-)	1.42	3.41
BoA Merrill High Yield	(B+)	2.71	16.75
BoA Merrill EM Corporate Plus	(BBB)	2.99	8.68
BoA Merrill Global Gov't ex-US	(AA-)	-0.60	-0.55
JPM Emerging Markets EMBI+	(BB+)	3.78	7.39
JPM CEMBI Broad	(BBB-)	3.15	9.58
JPM GBI-EM Global Diversified	(BBB)	6.50	5.47

Benchmark Equities			
S&P 500	NA	5.53	14.71
Nasdaq Composite	NA	9.82	21.39
Russell 2000	NA	2.12	24.41
MSCI EAFE	NA	6.47	8.53
Europe	NA	6.73	6.51
Japan	NA	3.67	12.37
MSCI Emerging Markets Equity	NA	11.14	14.53

Markets

In contrast to the noise and acrimony coming out of Washington, financial markets had a quiet quarter. The VIX traded in a narrow range of about 10.5 to 13.2, marking the least volatile quarter in over 5 years. Investors have been waiting for promised policy changes, which raised expectations, and supported higher equity prices globally. On the economic data front, confidence measures remained elevated post-election, although some indicators missed and economists lowered first quarter forecasts. Ignoring the data, Washington politics, populist fever in Europe, and geopolitical noise, global equities had a stellar quarter. U.S. equities gained 5.53%, European stocks rose 6.73% in USD terms, and EM equities returned 11.14%. Meanwhile, interest rates, which rose after the election and continued higher into mid-March, reversed course after the Fed hiked the Fed Funds rate on March 15. By quarter-end, U.S. rates were not much changed leaving bonds with modest returns. The dollar, widely expected to appreciate as the year began, was mostly lower and commodities, which enjoyed a post-election boost, also ended the quarter lower.

High yield bonds held on to the momentum they had in 2016, supported mostly by improving creditworthiness. The Bank of America Merrill Lynch High Yield Cash Pay Index (J0A0) ended up 2.71% for the quarter. Spreads to worst narrowed from 429 b.p. to 391 b.p., while the yield to worst decreased from 6.07% to 5.67%. Despite strong performance, apprehension over valuations in the high yield market led investors to withdraw funds from the sector. For the quarter, outflows totaled $7.4 billion, with almost all of the departure occurring in March. The default rate decreased to 1.90% in March from 3.57% in December after dropping last year's energy-heavy defaulters from the calculation. New issue activity jumped to $98.7 billion nearly double last year's first quarter and the eighth highest on record.

The investment grade corporate bond index, the Bank of America Merrill Lynch U.S. Corporate Index (C0A0), was up 1.42% for the quarter supported by ample investor demand and robust issuance as interest rates were relatively stable. Corporate bonds continued to outperform government bonds, although most of the outperformance occurred in January and February. During the quarter, the U.S. treasury index returned 0.69%. Corporate option adjusted spreads (OAS) narrowed by 8 b.p. to 122 b.p., while the yield to worst of the index decreased from 3.40% to 3.31%. Issuance for the quarter spiked to $448.3 billion, the highest quarterly volume on record, as borrowers raced to refinance ahead of expected higher interest rates and possible corporate tax changes.

Emerging markets bonds delivered surprisingly good performance given fears over Trump's trade policies, interest rates and the U.S. dollar. Favorable flows of funds, higher commodity prices and stable economic activity helped the sector overcome Trump-related fears. For the quarter, the JPM Emerging Markets Bond Index Plus (EMBI+), a dollar denominated sovereign index, was up 3.78%, the JPM Corporate Emerging Markets Broad Index (CEMBI Broad) increased 3.15%, and the JPM Global Bond Index – Emerging Markets Global Diversified (GBI-EM Global Diversified), a local markets index, returned 6.50%.

Portfolios

Our *Core Plus Composite* consists of portfolios that can hold up to 30% in securities rated below investment grade. The Composite outperformed the Bloomberg Barclays U.S. Aggregate Index, net of fees, by 88 b.p. for the quarter, and was ahead by 437 b.p. over the last twelve months. During the quarter, the best performing sector was emerging markets followed by high yield and investment grade credit. In aggregate, the Composite had exposure exceeding 49.3% to credit sectors, with exposure to non-investment grade rated securities approaching 16.0%. Exposures to high yield and emerging markets explain most of the outperformance. The portfolio was underweight mortgages and government bonds, both of which underperformed as interest rates rose through the middle of March. Over the last 12 months all credit markets outperformed, with high yield and emerging markets doing particularly well. The portfolios held overweight exposures all year, which accounted for the bulk of the outperformance.

Global Credit Plus Composite consists of portfolios holding investment and non-investment grade credit related securities. The Composite is measured against a benchmark consisting 70% of the BofA Merrill Lynch U.S. Corporate Index and 30% of the BofA Merrill Lynch U.S. Cash Pay High Yield Index. The Composite outperformed the benchmark, net of fees, by 21 b.p. during the quarter, but was behind by 112 b.p. over the last twelve months. The portfolios had an allocation of approximately 76.7% U.S. investment grade, 10.7% high yield, and 12.6% emerging markets, of which 10.0% was investment grade rated. In the first quarter, emerging markets and high yield outperformed investment grade as policy optimism and improved creditworthiness supported the riskier sectors. For the quarter, the exposure to emerging markets and favorable security selection helped generate the outperformance. Over the last twelve months, high yield generated the best credit sector performance. Emerging markets bonds did well, but underperformed high yield. The portfolios' underweight in high yield caused the Composite's relative underperformance.

Our *Global High Yield Composite* consists of portfolios investing primarily in U.S. high yield, higher yielding investment grade credit and emerging markets corporate bonds. The Composite outperformed the Bank of America Merrill High Yield Cash Pay Index by 50 b.p., net of fees, in the quarter, and was ahead of the index by 316 b.p. over the last 12 months. Higher yielding fixed income sectors continued to outperform in the first quarter. Emerging markets did better than high yield as it benefited from continuing inflows. The portfolios had exposure of about 20.7% to emerging markets, which helped generate outperformance in the quarter. Over the last twelve months, the outperformance was attributable to a combination of favorable industry allocation, security selection and a recovery in certain emerging markets, like Brazil, which helped the Composite outperform the high yield sector's impressive performance.

Our *Emerging Market Debt Composite* consists of portfolios investing in dollar denominated emerging market credit securities, primarily from corporate issuers. The Composite is measured against the BofA Merrill Lynch US Emerging Markets Plus Index (EMUB). During the quarter the portfolio outperformed the benchmark by 62 b.p., net of fees, and was ahead by 287 b.p. over the last twelve months. During the quarter and over the last twelve months non-investment grade outperformed investment grade and Latin America outperformed Asia. The portfolio's overweight positions in Latin America, primarily Brazil, and in non-investment grade credit generated the bulk of the outperformance. Asian exposure in the emerging markets corporate indexes tends to be high quality and subject to movements in interest rates. Asia underperformed as interest rates rose through mid-March, even though they ended the quarter mostly unchanged.

Economy

The new administration completed a turbulent 75 days in office. Even Trump's own party opposed him on a partisan promise to improve healthcare, and personnel instability has given the impression the White House is disorganized and lacks direction. Nevertheless, consumer and business confidence measures remain elevated, stock markets hit a record high on March 1, 2017, and the Fed took a preemptive measure against inflation by raising rates on March 15. During the quarter, some economic data in the U.S. softened, but not by enough to abandon the optimism. Although 75 days is little in a four year presidential term, opposition to Trump and his agenda has sufficed to nick the market's conviction that his policy proposals will become reality.

Although many economists lowered 1Q forecasts after modestly disappointing data, most still expect improvement later in the year. In the Wall Street Journal March Economic Survey, respondents downgraded 1Q but upgraded 2Q and left 3Q and 4Q at 2.5% growth on average. They also continued to handicap their forecasts more to the upside than downside suggesting continued optimism over the policy outlook. As we write this, three significant events occurred on April 7: the Trump administration launched an air strike against Syria, Neil Gorsuch was confirmed to the Supreme Court, and the April non-farm payroll report came out well below consensus. None of these have meaningful traction in isolation, but two are considered Trump administration victories and the other may embolden congressional action on tax reform.

As much as data has softened in the U.S., it has improved in Europe. Germany, in particular, reported improved manufacturing and services data, probably driven by the weaker currency and a nice lift in European auto sales. The U.K. also performed surprisingly well given fears of deterioration after the Brexit vote last June. Other economies that have done better include China and India, while a disappointer has been Brazil. Overall, J.P. Morgan expects global growth to be 3.3% for the first quarter of 2017, well above expectations last year prior to the U.S. election.

While we remain broadly optimistic and place weight on confidence indicators from consumers and small business, we recognize that some of the negative factors have traction. Specifically, the current expansion, while tepid by historical standards, has been in place for years and may be losing momentum. The unemployment rate came in at 4.5% in the April reading, a number that may well be near full employment leading to possible labor shortages and production disruptions. Also, dysfunction in Washington may jeopardize the Administration's tax reform plans and the geopolitical landscape (including elections in Europe) may deliver unwanted surprises.

Scenarios

We propose three scenarios for the U.S. economy over the next 6 months:

1. Our most likely case has the economy growing between 2.0% and 2.5% in 2Q and between 2.5% and 3.0% 3Q 2017. We believe the Administration can still successfully execute corporate tax reform and mandate deregulation across many industries. The U.S. economy already enjoys momentum from low unemployment, low oil prices, elevated consumer confidence, and low inflation. While stronger growth may change inflation expectations, the Fed appears ready to face that prospect and, thus far, their rate hikes have not put brakes on the economy. We believe infrastructure spending will be slower to materialize and budget deficits will begin to moderate as taxes from higher activity materialize. While the dollar fell during the quarter, its trajectory is probably higher, which may also aid growth abroad. PROBABILITY 60%

2. A second scenario has the economy recovering to trend or above-trend growth of 3.0% to 3.25% over the next six months. With an unemployment rate of 4.5%, new investment may consume economic slack quickly, boost consumption more than expected and push growth higher. The modestly weaker data recorded in 1Q may be reversed as wages rise and optimism encourages consumption. Success in corporate tax reform and deregulation may disproportionately benefit small businesses, which have been weaker-than-normal contributors to the post-2009 expansion. In addition, it appears foreign economies have turned the corner and will be larger contributors to global growth. PROBABILITY 20%

3. A third scenario has the economy declining to a 0.5% to 1.0% growth rate due to failure to enact growth-oriented tax reform, or worse, a prioritization of trade protectionism and tariffs. Obstructionism and rancor in congress may quickly erode confidence and delay business investment. Some of the economy's tailwinds, like wage and employment growth, strong auto sales and new home construction may also falter with higher economic uncertainty. Elections in Europe may further strain the Union and geopolitical concerns may divert attention away from the economy. Put together, these conditions would weigh the U.S. economy down sapping its growth rate. PROBABILITY 20%

Market Outlook

Markets have been surprisingly complacent, driven by optimism over economic policy. While some economic indicators support loftier financial market valuations, many have disappointed. Acrimony in Washington and errors by the new administration suggest market complacency may be short-lived. Investors' challenges involve juxtaposing, an economy that is in good, although not perfect shape, but could receive a boost from favorable policy, with a seemly dysfunctional

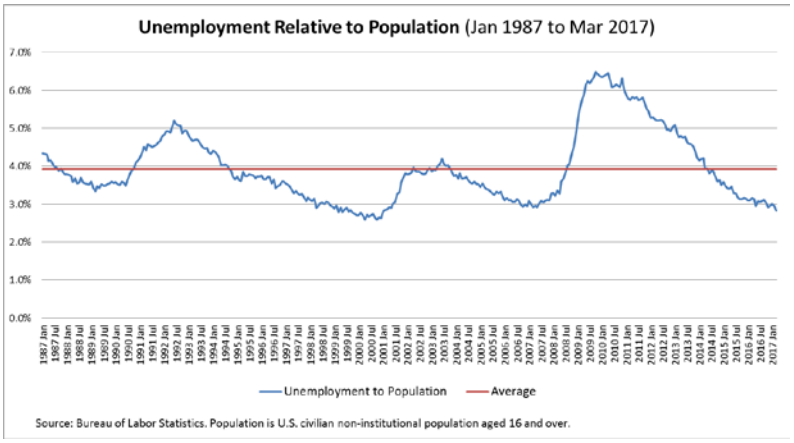
and obstructionist government. Toward quarter-end many investors began to reduce risk. We continue to believe conditions are in place for the economy to perform better than expected and for some form of tax relief to materialize. Our forecast of higher rates remains intact and we believe credit markets will outperform, but mostly because of excess yield rather than spread compression. Like many, we began to reduce risk in our portfolios in case markets become impatient or the government's dysfunction becomes detrimental.

Commentary – On Unemployment, Demographics and Growth

On April 7, 2017 the widely anticipated employment data for March showed that the most followed number, the change in Nonfarm Payrolls, came in well below expectations (98,000 vs 180,000), and appeared surprisingly weak compared to the ADP number published two days before. Less noticed was a 0.2% drop in the unemployment rate to 4.5% which resulted from a sizeable 472,000 employment gain in the Department of Labor's Household Survey. The Federal Reserve (Fed) has a dual mandate to control inflation and maximize employment. The Fed raised rates on March 15, 2017, a move that was unexpected in early February, and indicated they will likely raise rates again a few times in 2017. The market is well aware of the Fed's inflation target, 2%, but has less clarity on the unemployment target. How should markets interpret March's employment release?

From March 15 through April 12 the S&P 500 declined 1.7% and the 10-year U.S. treasury yield fell 36 basis points from 2.60% to 2.24%. The short-term market reaction might be interpreted to reflect concern over the economy and its prospects. However, at 4.5% the unemployment rate is the lowest it has been since May 2007, and not far from the low prints over the last 30 years. At the same time, given the country's demographic composition, the size of the economy, and labor market conditions, we think the employment data may tell a different story than the markets are reflecting.

In our 1Q 2013 Commentary we wrote about the falling Labor Force Participation Rate, noting that it was likely a secular trend because the "baby boom generation" was beginning to retire. We used data from the 2010 Census which shows that the two largest 5-year population cohorts have begun to retire, the smallest cohort is traversing its most productive years, and the third largest cohort, baby boomer kids, is now in its early stages of work. Even with the baby boomer kids added, over the next decade, people reaching age 65 will exceed people reaching age 15 or 20 meaning the participation rate will likely tend to decline. Since the unemployment rate is the number of people not working divided by the number of workers (the participants), relatively, the number of unemployed is close to levels seen in 2000, the best year in the last 30. The chart to the right shows the number of unemployed relative to the total non-institutional population, rather than just the participants. Alternatively, if we had the same labor force participation rate now as existed in April 2000 when the unemployment rate was 3.8%, the number would be 4.2% rather than 4.5%.



After the recession in 2008-2009, the Fed and many private sector economists began to argue that the "natural rate of unemployment," which can be thought of as the rate at which the economy is operating at its potential long-term growth pace (i.e. between 2.0% and 3.0%) had risen. In a 2010 Commentary entitled "Unemployment after the Recession: A New Natural Rate?," authors Murat Tasci and Saeed Zaman of the Federal Reserve Bank of Cleveland argued the

unemployment rate's long term trend was higher and modeled the Natural Rate to be between 5% and 6%. After the 2008-2009 recession unemployment spiked and the Fed was forced to take extraordinary measures. Even as the unemployment rate declined, the Fed was slow to withdraw stimulus for fear of derailing an economy that seemed unable to gain momentum. Almost certainly, as the unemployment rate broke through 5.0% in January 2016, shortly after their first rate hike since the recession, the Fed disregarded all notions of a Natural Rate exceeding 5.0%. Now the Fed insists it wants to be ahead of the curve, but with a dramatic shift in Washington's economic policy priorities since the election, it may already be behind.

In 2000, when the unemployment rate averaged 3.97%, GDP was approximately $87,000 per active worker. Year 2000 came at the end of the "tech boom," which brought tremendous investment, partly due to fears that many computer systems were not coded to handle the turn of the century. In 2016, each active worker produced about $104,000 of GDP. A puzzling feature of the post-recession recovery has been the absence of investment. We have argued that comprehensive corporate tax reform could bring a wave of investment, which could boost growth and further increase employment. If this occurred and the unemployment rate reached the April 2000 level of 3.8%, we estimate the growth effect could be 0.75 to 1.0%. However, the labor market is tight and might, surprisingly, be a hurdle rather than an impetus to growth. In the last 30 years the average annual unemployment rate was under 5.0% in only 8 years (including 2016) and under 4.5% in only 2 (1999 and 2000). We believe we can get back to 4.0% with the right policy mix, but we wonder whether the monetary and fiscal authorities will be bold enough to get us there.

Sources: Bureau of Labor Statistics, Bureau of Economic Analysis, Federal Reserve Bank of Cleveland, Federal Reserve Bank, Census Bureau.

April 15, 2017

Important Information

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Index Definitions

Bloomberg Barclays US Aggregate Index

The Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

Bloomberg Barclays US Treasury Index

This index is the U.S. Treasury component of the U.S. Government index. Public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Bloomberg Barclays US Government/Credit Index

The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries and agencies. The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

Bloomberg Barclays US Credit Index

This index is the U.S. Credit component of the U.S. Government/Credit index. Publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

Bloomberg Barclays US Mortgage Backed Securities Index

This index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Bank of America Merrill Lynch US Corporate & Yankees Index

The Bank of America Merrill Lynch US Corporate & Yankees Index tracks the performance of US dollar denominated investment grade debt publicly issued in the US domestic market by US and non-US corporations and non-US quasi-governments.

Bank of America Merrill Lynch US Corporate Index

The Bank of America Merrill Lynch US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch) and an investment grade rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long term sovereign debt ratings).

Bank of America Merrill Lynch US High Yield Master Cash Pay Only Index

The US High Yield Master Cash Pay Only Index tracks the performance of below investment grade US dollar-denominated corporate bonds publicly issued in the US domestic market.

Bank of America Merrill Lynch Global Government Excluding the U.S. Index (N0G1)
The Global Government Index tracks the performance of publicly issued investment grade sovereign debt denominated in the issuer's own domestic currency. N0G1 excludes U.S. government bonds.

JP Morgan Corporate Emerging Markets Bond Index (CEMBI)
The CEMBI tracks total returns of US dollar-denominated debt instruments issued by corporate entities in Emerging Markets countries. Two variations are available: CEMBI Broad and CEMBI. The CEMBI Broad is the most comprehensive corporate benchmark followed by the CEMBI, which consists of an investable universe of corporate bonds. Both indices are also available in Diversified versions.

JP Morgan EMBI+ Index
The EMBI+ tracks total returns for U.S-dollar-denominated debt instruments of the emerging markets: Brady bonds, loans, Eurobonds. The EMBI+ currently covers 104 instruments across 15 countries.

JP Morgan Government Bond Index-Emerging Markets (GBI-EM)
The GBI-EM is the first comprehensive, global local Emerging Markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. Variations of the index are available to allow investors to select the most appropriate benchmark for their objectives.

S&P 500 Index
An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

Nasdaq Composite Index
An index that tracks the change in the total market value of all companies listed on the Nasdaq Stock Market.

Russell 2000 Index
An index measuring the performance of the 2,000 smallest companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small cap stocks in the United States.

MSCI EAFE Index
The index is a capitalization weighted index that monitors the performance of stocks from Europe, Australasia and the Far East.

MSCI EAFE- Europe Index
The index is a capitalization weighted index that monitors the performance of stocks from Europe.

MSCI EAFE- Japan Index
The index is a capitalization weighted index that monitors the performance of stocks from Japan.

MSCI Emerging Markets Equity
The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.