GIA PARTNERS

2nd Quarter 2017

Highlights

- Financial markets continued to perform well driven more by sentiment than economic data. Credit markets continued to outperform and our portfolios benefited.
- Economic data improved in June likely leading to a strong GDP print for the second quarter. Combined with a weak 1Q, year-to-date the economy continues on a modest growth path.
- With better economic performance globally, monetary authorities are winding down their extraordinary policies. We believe this is good news and supportive of higher asset valuations.

Markets

		Returns (%)	
GIA*	Average Quality	2Q17	12 Months
Core Plus Composite	(A)	1.61	3.18
Global Credit Plus Composite	(BBB+)	1.80	4.27
Emerging Market Debt Composite	(BB+)	2.06	8.83

**Returns are net of fees*

Benchmark Bonds			
Bloomberg Barclay's U.S. Agg. Index	(AA+)	1.45	-0.31
Treasury	(AAA)	1.19	-2.32
Credit	(A)	2.35	1.84
Mortgage	(AAA)	0.88	-0.06
Government/Credit	(AA)	1.69	-0.41
BoA Merrill U.S. Corps & Yankees	(A)	2.22	1.98
BoA Merrill Corporate Master	(A-)	2.42	2.33
BoA Merrill High Yield	(B+)	2.16	12.75
BoA Merrill EM Corporate Plus	(BBB)	1.50	5.93
BoA Merrill Global Gov't ex-US	(AA-)	0.10	-3.27
JPM Emerging Markets EMBI+	(BB+)	2.40	3.75
JPM CEMBI Broad	(BBB-)	1.66	6.96
JPM GBI-EM Global Diversified	(BBB)	3.62	6.41

Benchmark Equities			
S&P 500	NA	2.57	15.46
Nasdaq Composite	NA	3.87	26.80
Russell 2000	NA	2.12	22.87
MSCI EAFE	NA	5.03	17.08
Europe	NA	5.93	17.80
Japan	NA	5.02	16.98
MSCI Emerging Markets Equity	NA	5.47	21.18

Markets

Financial markets had another strong performance quarter driven more by sentiment than by concrete data. First quarter corporate earnings exceeded expectations, but were accompanied by softer economic data and setbacks on the policy front for the Trump administration. Nevertheless, the S&P 500 gained 2.57% in the second quarter, posting many record closes and an 8.24% return year-to-date. Ironically, longer-term government bond yields started declining in March, the day before the Fed's first 2017 rate hike and hit a year-to-date low on June 14, the date of the Fed's second rate hike. Bonds reacted to the absence of inflation and soft economic data, but did not derail the equity market. Like the first quarter, volatility was mostly dormant, a surprise given the confluence of factors influencing the markets. Optimism was not limited to the U.S. European equity markets performed especially well as economic data there suggested the region is improving, and the European Central Bank initiated plans to withdraw stimulus. Emerging markets also outperformed due more to positive fund flows than to favorable data as commodity prices declined and concern mounted over China's debt markets.

High yield bonds delivered another good quarter driven by earnings and recovering creditworthiness even though, unlike other "risky" sectors, the asset class suffered outflows from retail investors. The Bank of America Merrill Lynch High Yield Cash Pay Index (J0A0) ended up 2.16% for the quarter and 4.93% year-to-date. Spreads to worst narrowed from 391 b.p. to 381 b.p., while the yield to worst decreased from 5.67% to 5.59%. Continued apprehension over valuations in the high yield market led investors to withdraw funds for a second consecutive quarter. For the quarter, outflows totaled $1.34 billion, bringing year-to-date outflows to $9.5 billion. The default rate decreased to 1.50% in June from 1.90% in March after dropping $34.8 billion of primarily energy related year-ago defaults from the calculation. New issue activity remained healthy at $76.7 billion for the quarter and $175.3 billion for the first half of 2017. This total comfortably exceeded last year's first half issuance as investors willingly absorbed the supply.

The investment grade corporate bond index, the Bank of America Merrill Lynch U.S. Corporate Index (C0A0), was up 2.42% for the quarter supported by a decline in longer term rates, modest spread compression and ongoing investor demand. Corporate bonds continued to outperform government bonds in part because the yield curve flattened and the corporate index has a longer duration than the treasury index. During the quarter, the U.S. treasury index returned 1.22%. Corporate option adjusted spreads (OAS) narrowed by 7 b.p. to 115 b.p., while the yield to worst of the index decreased from 3.31% to 3.22%. Issuance for the quarter remained strong at $334.5 billion, which brought year-to-date borrowing to $793.9 billion, on pace for a sixth consecutive annual record.

Emerging markets bonds delivered another good quarter of performance, although not as strong as the first quarter of 2017. Funds continued to flow into emerging markets even though high yield investors withdrew funds from that sector. General optimism helped the sector overcome a new scandal in Brazil, weakness in commodity prices and softer economic data in China. For the quarter, the JPM Emerging Markets Bond Index Plus (EMBI+), a dollar denominated sovereign index, was up 2.40%, the JPM Corporate Emerging Markets Broad Index (CEMBI Broad) increased 1.66%, and the JPM Global Bond Index – Emerging Markets Global Diversified (GBI-EM Global Diversified), a local markets index, returned 3.62%. Year-to-date the indexes are up 6.27%, 4.86% and 10.36% respectively.

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 16 b.p. for the quarter, and was ahead by 349 b.p. over the last twelve months. During the quarter, the best performing sector was investment grade credit, following some spread compression and lower rates. High yield and emerging markets followed with relatively stable spreads, but higher yields in the short end of the curve. In aggregate, the Composite had exposure of 49.2% to credit sectors, with exposure to non-investment grade rated securities approaching 16.1%. 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 in the short end of the yield curve rose on the back of two rate hikes. 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 85% of the BofA Merrill Lynch U.S. Corporate & Yankees Index and 15% of the BofA Merrill Lynch U.S. Cash Pay High Yield Index. The Composite underperformed the benchmark, net of fees, by 41 b.p. during the quarter, and outperformed by 73 b.p. over the last twelve months. The portfolios had an allocation of approximately 76.5% U.S. investment grade, 11.3% high yield, and 10.3% emerging markets, of which 10.0% was investment grade rated. After underperforming during the first half of 2016, high yield had the best performance in fixed income over the last twelve months. While the portfolio was underweight high yield, it was overweight emerging markets, which outperformed investment grade corporates. The emerging markets performance benefit more than offset the high yield underweight over the last twelve months.

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 56 b.p., net of fees, and was ahead by 290 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 even though longer term rates declined slightly as many of the region's securities have shorter maturities.

Economy

It could be argued that the stock market is trading on sentiment, which remains elevated. While data improved during the second quarter, through mid-year, growth was modest. On the positive side, first quarter earnings delivered a favorable surprise, and the unemployment rate hit a post 2008 low. Also, inflation did not materialize despite low unemployment, and June data confirmed a second quarter rebound that puts first-half 2017 growth back on a 2.0 to 2.5% pace. On the negative side, auto sales cooled, housing construction and turnover disappointed, investment stayed soggy and the Administration made limited progress on economic priorities. Economic optimists point to stubbornly high confidence measures and likely corporate tax reductions to forecast higher growth rates. Pessimists believe the economy may roll over soon as the lack of wage growth and investment will derail an overly long expansion.

On balance, economists have tempered their post-election enthusiasm as data and the policy environment soured. In the June WSJ Economic Survey 50.9% of respondents indicated the risk to their forecast was downward and only 38.2% responded upward. This is notable because those numbers approximate respondents' pre-election outlooks, which had flipped to positive after Trump's election. Having gone full circle in the U.S., most economists upgraded their outlook for European and global growth. It is also noteworthy that emerging markets remained healthy in the face of central bank rate hikes and a prediction of stronger U.S. dollar. We believe this largely reflects expectations for better commodity prices and improving policy frameworks in the major EM economies.

Meanwhile the world's major central banks have indicated a preference for higher rates and the withdrawal of stimulus. In fact, we can now contemplate a global economy that stands on its own without monetary crutches. A return to market determined interest rates should be healthy for capital allocation, investment and resource development. While that remains months, if not years, away, we believe markets have so far reacted in an orderly manner supporting that exit.

A final observation is that, on average, economists continue see a low probability of recession. At 16% the average matches expectations during all of 2017 and remains lower than the 20% average prior to the election. Over the last five years economic optimism has been derailed by factors like swooning commodity prices, a European sovereign debt crisis, and Chinese attempts to reign in credit. While new types of events are likely in the future, the U.S. economy's foundation seems robust enough now to deal with any collateral effects.

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 3Q and 4Q 2017. We believe the economy is showing sufficient resilience in housing, labor markets and in various service industries to offset softening in autos and other manufacturing. Even with a tight labor market, inflation will probably behave because oil markets will likely remain well supplied and consumer goods face competition. European growth provides a needed boost to the global economy, and China will likely manage its economy to a desired rate of growth. While many would prefer a faster pace of growth in the U.S., this level can prevail for a few years, especially if tax reform takes longer to achieve. PROBABILITY 60%

2. A second scenario has the economy recovering to above-trend growth of 3.0% to 3.25% over the next six months. With an unemployment rate of 4.4%, new investment may consume economic slack quickly, boost consumption more than expected and push growth higher. The relatively robust June data and sustained optimism may encourage 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, further improvements in Europe, China and Japan may consolidate a stronger global economic outlook. PROBABILITY 20%

3. A third scenario has the economy declining to a 0.5% to 1.0% growth rate due to failures on the policy side. The healthcare set-back may embolden opponents of tax reform causing a reversal in sentiment and cancellation of potential new investments. Obstructionism and rancor in Washington may cause a correction in financial markets which can further erode confidence. Some of the economy's tailwinds, like wage and employment growth and new home construction may falter with higher economic uncertainty. China may curtail excess credit in its shadow banking system with a consequent growth impact that may be felt globally via commodity prices and slower emerging market growth. PROBABILITY 20%

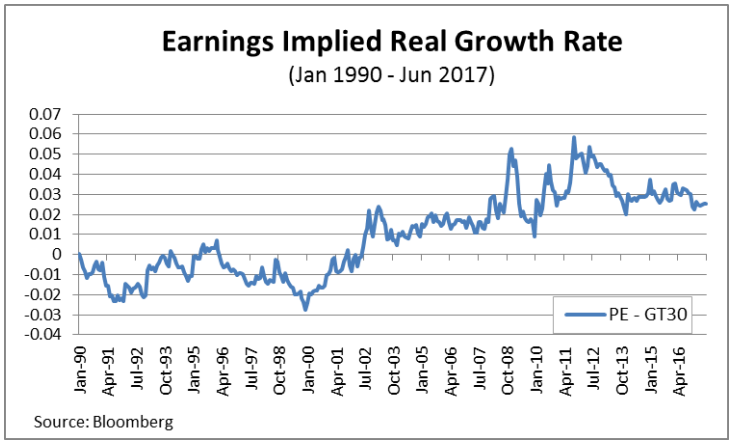
Market Outlook

The second quarter move lower in longer term rates caught many by surprise. Ostensibly, the reason was an absence of inflation. However, the Fed raised rates twice, ignoring the cautious message from long term interest rate markets. We continue to believe that favorable actions will be taken on corporate taxes, which would justify the Fed's moves and higher rates. With the European economy performing better and global central banks eager to exit their unconventional stimulus policies, it is feasible that global yield curves begin to normalize at higher rates. If all of this happens in the context of stronger growth, which we believe likely, higher risk markets should continue to enjoy investor attention. We believe it is more likely that credit spreads, for example, trade in a narrow range generating some outperformance, although with lower absolute returns.

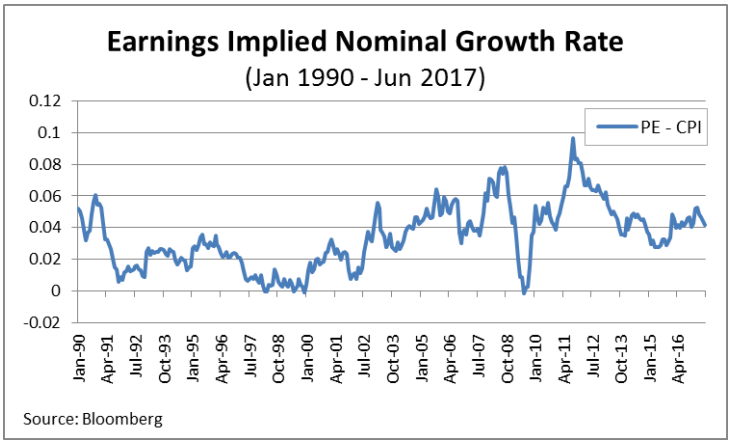
Commentary – Are Valuations Excessive?

Equity values rose substantially over the last few years and many national and global indexes posted many record closes this year. Over the last five years, the S&P 500 delivered an annualized return of 12.2% despite relatively sluggish economic growth, modest inflation and a confluence of global concerns. By comparison, during that same time period, U.S. bonds returned 2.2% and U.S. high yield delivered 6.9% per annum. Like equities, riskier bonds outperformed government bonds and currently trade at historically tight spreads leading some investors to warn of overvaluation. But are valuations truly excessive?

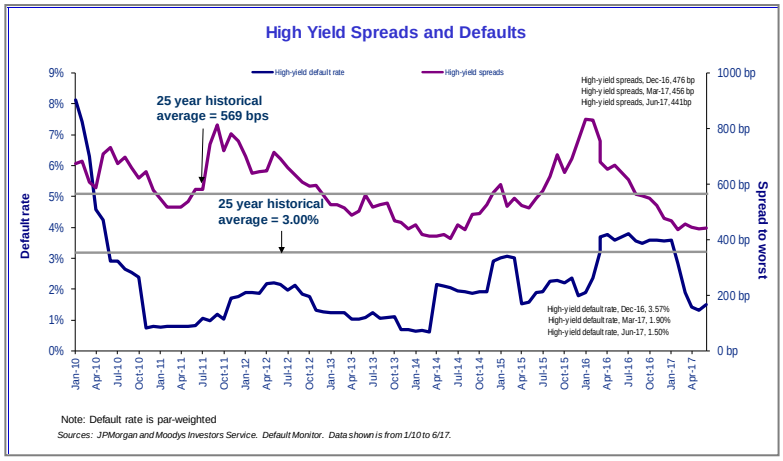
In investing – and other aspects of life – everything is relative. This becomes particularly relevant when one of the relative measures is being artificially inflated, as bonds have been by the Federal Reserve since the 2008 - 2009 recession. One reasonable analysis is to estimate the implied economic growth rate in equity pricing. Using asset pricing comparables, we can invert the price earnings ratio to obtain a market indicated static equity "yield." If we subtract the yield of the long bond, we get the market's implied growth assumption, which, for a broad equity index like the S&P 500, may be considered akin to GDP growth. The graph shows the S&P 500's growth assumption using this measure. At June 30, 2017, the level was 2.5%, eerily close to the average growth forecast of the WSJ Survey economists. Clearly, this is a simplistic measure of equity valuation, but it provides a reasonable assessment of how equity valuations look relative to an alternative long duration credit-risk free investment.



Because of the forward-looking nature of asset prices, an alternative picture can be obtained by subtracting inflation from the equity "yield" to obtain a nominal growth measure. This computation has the benefit of extracting the depressing effect on bond yields of the Fed's quantitative easing policies. The result, in Chart 2 below, does not suggest growth expectations for the S&P 500 are excessive even if, historically, higher inflation rates implied lower nominal earnings growth.



Another area that generates concern is the high yield market as some investors believe spreads do not compensate for the risk. Below is a graph of high yield spreads and default rates. After last year's default-heavy first half (due to faltering commodity and energy companies), the default rate returned to a historically low level. In the high yield market a measure of valuation involves a calculation of post default implied spreads. As noted above, as of June 30, 2017 the BAML high yield index spread was 381 basis points. J.P. Morgan is forecasting a high yield default rate of 2.0% for 2017 and 2018. Assuming a recovery rate of 40% (compared to a 25 year average of 41.2%) on a forecast of 2.0% defaults over the next year, the net investor benefit of owning high yield would be 261 basis points, still comfortably higher than the 115 basis point spread compensation for higher rated bonds.



One of the benefits of the Fed's rate hikes and balance sheet reduction should be the return of market based interest rate determination. The effective subsidization of rates through bond purchase programs can distort market valuations because the discount rate used for project analysis, growth projections, and asset allocation would likely be different without a purchaser whose sole incentive is to lower rates. It is also gratifying to see the European Central Bank and Bank of Japan preparing for the withdrawal of their extraordinary market interventions.

None of this would occur if the economies of the U.S., Europe and Japan were not robust enough to stand alone. The world suffered a great financial shock nine years ago, and it has been discouraging the recovery took so long and required such extreme measures. We believe a return to a world of undistorted and unsubsidized free markets should be good for the global economy and for financial assets. Given where we are, where we have been and where we appear to be headed, high valuations seem reasonably appropriate.

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July 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.