GIA PARTNERS

3rd Quarter 2017

Highlights

- U.S. stock markets closed at record highs and in fixed income, credit markets outperformed. Our portfolios benefited from tighter credit spreads;
- Global economic data improved in 3Q leading economists to raise their forecasts for 2017 and beyond. It appears the world's largest economies may finally be able to stand on their own;
- The absence of inflation in 2017 has vexed monetary authorities and economists. We believe inflation is coming, in part, because labor markets in the U.S. may experience shortages.

Markets

		Returns (%)	
GIA*	Average Quality	3Q17	12 Months
Core Plus Composite	(A)	1.29	2.69
Global Credit Plus Composite	(BBB+)	1.29	3.01
Emerging Market Debt Composite	(BB+)	3.43	8.82

**Returns are net of fees*

Benchmark Bonds			
Bloomberg Barclay's U.S. Agg. Index	(AA+)	0.85	0.07
Treasury	(AAA)	0.38	-1.67
Credit	(A)	1.35	1.96
Mortgage	(AAA)	0.96	0.30
Government/Credit	(AA)	0.81	-0.01
BoA Merrill U.S. Corps & Yankees	(A-)	1.32	1.99
BoA Merrill Corporate Master	(A-)	1.37	2.27
BoA Merrill High Yield	(B+)	2.05	9.06
BoA Merrill EM Corporate Plus	(BBB)	2.15	5.05
BoA Merrill Global Gov't ex-US	(AA-)	0.25	-2.71
JPM Emerging Markets EMBI+	(BB+)	2.23	2.86
JPM CEMBI Broad	(BBB-)	2.28	6.00
JPM GBI-EM Global Diversified	(BBB)	3.55	7.32

Benchmark Equities			
S&P 500	NA	3.96	16.19
Nasdaq Composite	NA	5.79	22.29
Russell 2000	NA	5.33	19.11
MSCI EAFE	NA	4.81	15.99
Europe	NA	6.02	18.99
Japan	NA	3.23	12.08
MSCI Emerging Markets Equity	NA	7.02	19.73

Markets

In a quarter punctuated by extreme weather in the U.S., earthquakes in Mexico, geopolitical sabre rattling and social rancor, equity markets hit new record highs and economic activity flourished. As happened earlier in 2017, financial markets seemed detached from noisy factors that, in other years, might have affected them. All major U.S. equity indexes closed at record highs in September and global equity performance was similarly compelling. Bond investors did not fare as well because interest rates edged higher in September after the Fed reiterated its intention to continue raising rates and introduced a modestly more aggressive than expected balance sheet normalization plan. Nevertheless, credit markets outperformed, supported by economic data, falling default rates and torrents of foreign money. Commodities also rose led by oil and metals. The big surprise in the face of this robust picture for U.S. financial markets was the U.S. dollar, which declined against the Euro and many emerging market currencies.

The investment grade corporate bond index, the Bank of America Merrill Lynch U.S. Corporate Index (C0A0), was up 1.37% for the quarter supported by further spread compression, outperformance of the longer end of the yield curve and ongoing investor flows. In part, corporate bonds outperformed government bonds 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 0.39%. Corporate option adjusted spreads (OAS) narrowed by 9 b.p. to 106 b.p., while the yield to worst of the index decreased from 3.22% to 3.16%. Issuance for the quarter remained strong at $379.5 billion, which brought year-to-date borrowing to $1.17 trillion, well on pace for a sixth consecutive annual record.

High yield bonds delivered another strong quarter driven by earnings and economic optimism as the sector did not benefit from the supportive retail money flows other sectors enjoyed. The Bank of America Merrill Lynch High Yield Cash Pay Index (J0A0) ended up 2.05% for the quarter and 7.07% year-to-date. Spreads to worst narrowed from 381 b.p. to 357 b.p., while the yield to worst decreased from 5.59% to 5.34%. Despite positive flows in September, continued apprehension over valuations in the high yield market led retail investors to withdraw about $585 million from high yield mutual funds. Year-to-date retail outflows exceeded $11 billion, but institutional inflows continued to support the sector. The default rate decreased to 1.07% in September from 1.50% in June. Even with the Toys R Us default in September, the quarterly default volume was the lowest since the 4th quarter of 2013. New issue activity remained healthy at $79.8 billion for the quarter and $255.6 billion year-to-date. This total exceeded last year's nine month total by about 9.0%.

Global economic improvement aided a recovery in oil and mineral prices, which, in turn, carried emerging markets bonds to another quarter of outperformance. Funds continued to flow unimpeded into emerging markets even though high yield investors withdrew funds from that sector. With growth indicators improving, investors overlooked political scandals in countries like Brazil, Mexico and South Africa. For the quarter, the JPM Emerging Markets Bond Index Plus (EMBI+), a dollar denominated sovereign index, was up 2.23%, the JPM Corporate Emerging Markets Broad Index (CEMBI Broad) increased 2.28%, and the JPM Global Bond Index – Emerging Markets Global Diversified (GBI-EM Global Diversified), a local markets index, returned 3.55%. Year-to-date the indexes are up 8.64%, 7.25% and 14.28% 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 44 b.p. for the quarter, and was ahead by 262 b.p. over the last twelve months. During the quarter, the best performing sector was emerging markets credit followed by high yield and investment grade credit. Each of these benefited from improving economic fundamentals and investor pursuit of yield. In aggregate, the Composite had exposure of 50.2% to credit sectors, with exposure to non-investment grade rated securities approaching 16.3%. Exposures to emerging markets and high yield 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 following the Fed's indication it intended to raise

rates again in 2017. 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 Index and 15% of the BofA Merrill Lynch U.S. Cash Pay High Yield Index. The Composite underperformed the benchmark, net of fees, by 13 b.p. during the quarter, and was behind by 2 b.p. over the last twelve months. The portfolios had an allocation of approximately 75.9% U.S. investment grade, 11.7% high yield, and 10.7% emerging markets, of which 10.0% was investment grade rated. The best performing sectors during the quarter were emerging markets high yield and U.S. high yield. The portfolio was underweight both of these, favoring investment grade rated credit. While emerging markets performed well, securities rated below investment grade performed better. The portfolio's underweight to below investment grade rated securities was responsible for the underperformance for the quarter and 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 128 b.p., net of fees, and was ahead by 377 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 market corporate indexes tends to be high quality and subject to movements in interest rates. Asia underperformed in September as rates rose after the Fed indicated it may raise rates again this year.

Economy

Economic data improved again in the third quarter driven by investment and robust employment. In late August and September, hurricanes Harvey, Irma, Jose and Maria hit Texas, Florida, Puerto Rico and various southern states. Their damage likely distorted some of the September data and will probably affect the numbers in 4Q. Even with this, the economy appears to have shifted into a new gear, which elevated valuations in the stock market, commodities, and credit spreads. Furthermore, at quarter-end the Trump administration introduced the preliminary parameters of a tax reform plan, which included a substantial reduction in corporate taxes.

The third quarter closed on perhaps the most favorable compilation of global economic data since before 2008. For the first time in years, all major regions of the world reported strong or improving results and troubled regions, like Europe, displayed a growth synchrony that has eluded member countries since the crisis. Even countries like Brazil and Russia that suffered after the decline of oil and commodity prices, showed early stages of recovery. In early October, the IMF increased its 2017 global growth forecast to 3.6% from 3.5%.

An interesting dynamic is that economists in the WSJ September Economic Survey did not raise their average 3Q and 4Q forecasts compared to August, but a few expressed greater optimism in separate commentary. Furthermore, the Fed and European Central Bank confirmed intentions to reduce or withdraw stimulus because their economies no longer need such accommodation. In fact, it would appear the global economy finally has the strength to grow without extraordinary monetary or fiscal policy support.

In the U.S., prior to the hurricanes, economic indicators suggested the economy was poised for a further growth spurt. Most significantly, the unemployment rate declined and the labor market showed signs of possible shortages. While inflation has not yet become a problem, the Fed seemed sufficiently concerned with that possibility to continue removing stimulus. The severity of the hurricanes' effect on the economy is not yet known, although new car sales for September pointed to a meaningful replacement boost. It is likely 4Q data will be distorted by the hurricanes, but the underlying growth trend will likely be better than reported.

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 2.5% and 3.0% in 4Q and 1Q 2018. The Institute for Supply Management's (ISM) September manufacturing and services readings indicated the economy was strengthening, despite the age of the current expansion. The September unemployment rate came in at 4.2%, the lowest post-recession print. While this is happening ahead of the hurricane-related distortions, it appears the economy may be experiencing a new growth phase. Adding economic improvements in Europe, Japan and most emerging markets, suggests a globally synchronized growth period may be ahead. All of this may be aided further by a growth oriented tax plan, if some of the proposed changes get enacted PROBABILITY 60%

2. A second scenario has the economy improving to above-trend growth of 3.25% to 3.5% over the next six months. With an unemployment rate of 4.2%, new investment may consume economic slack quickly, boost consumption more than expected and push growth higher. The relatively robust September data and sustained optimism may encourage consumption. Success in corporate tax reform and deregulation may disproportionately benefit small businesses, which have shown enough confidence to invest and hire more workers. In addition, further improvements in Europe and China may consolidate a better global economic outlook. PROBABILITY 25%

3. A third scenario has the economy declining to a 0.5% to 1.0% growth rate due to failures on the policy side and possibly destabilizing foreign events. Obstructionism and rancor in Washington may yet cause a correction in financial markets which can further erode confidence. Some of the economy's tailwinds like employment growth and consumer confidence may falter as a result of natural disasters and policy inertia. China may curtail excess credit in its shadow banking system with a consequent growth impact that will be felt globally via commodity prices and slower emerging market growth. PROBABILITY 15%

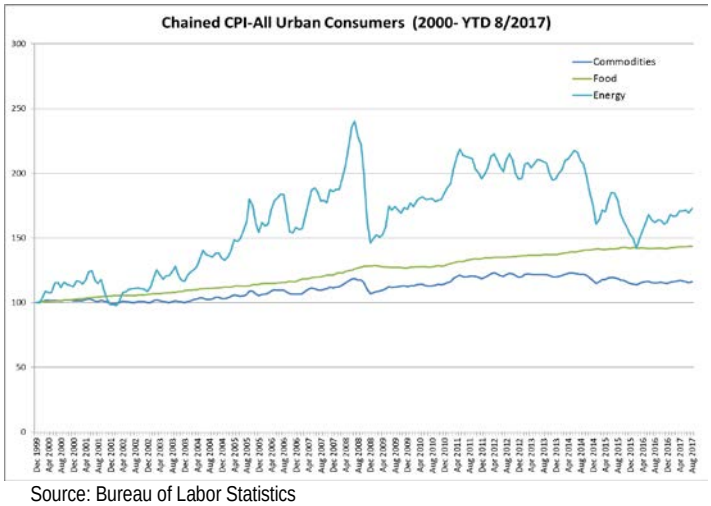
Market Outlook

An improved global economic outlook allows investors to focus more on fundamental growth prospects than monetary authority actions. This outlook may be aided further with tax reform in the U.S. and optimism around China's National Party Congress. We believe the absence of inflation is temporary, and the Fed is correct to proceed with further rate hikes and balance sheet normalization. While the ECB may be slower to exit its quantitative easing program, the region's peripheral economies appear to be recovering well enough to stand alone. All of this points to higher rates, although at likely lower absolute levels than historically when traversing similar economic conditions. Credit markets should continue to perform well, although higher rates will challenge their absolute performance. We recognize there is concern over valuations and the low levels of volatility, but we believe the broad outlook currently justifies the markets' levels.

Commentary – What Happened to Inflation?

A 2017 economic conundrum is the apparent absence of inflation in the face of strong U.S. employment and improving growth abroad. A still-accommodative central bank, robust economic data and improving corporate earnings only compound the puzzle. During 2017, a number of "one-off" effects seem to have restrained the Consumer Price Index (CPI), although these expenditure categories have modest weights in the overall index so it would appear something else might be holding back prices. A review of the data and labor market conditions suggest we may be living through a deferral of inflation, not a secular adjustment toward permanent containment.

Starting with information we know generically, but perhaps have not considered in detail, "things" we buy, other than food, have not risen in price for years. The chart below shows the Chained CPI data for commodities (physical things we buy), and breaks out two components, energy and food and beverages. Food constitutes over 40% of the Commodities Index and energy commodities make up another 9.5% so it is not surprising consumers feel a bit squeezed, even though we hear goods prices are not really rising. We believe a few meaningful developments account for the absence of inflation in things. The first is the globalization process and the expansion of free trade, which moved manufacturing to low cost jurisdictions. Technology has played an important role in reducing production costs, but betterment in that factor of production is not unique to recent years. A second, more recent and likely temporary phenomenon, is the decline in energy and metals prices, which eased input costs. The last might be described as the "Amazoning" of retail. The ability to shop efficiently online has two important effects, perfect price information and margin compression. Since consumers are able to view prices online and comparison shop, prices compress toward the marginal cost of production. While this technological advancement benefits consumers and forces manufacturers, retailers and distributors to become efficient, it does not eliminate inflation. Goods prices depend on the cost of materials, labor and technology needed to produce them. Efficiency in distribution minimizes the price consumers pay above the physical cost, but cannot reduce that cost over time.

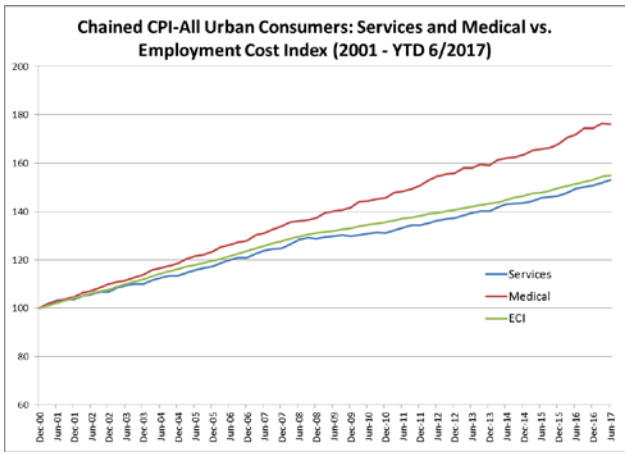


Source: Bureau of Labor Statistics

After 2008, U.S. corporations targeted efficiency improvements to reduce costs, in part by reducing employment. For years, analysts complimented corporate cost-cutting, but decried the absence of revenue growth. Discipline on the cost side and painful memories of lengthy unemployment may be responsible for the docile wage data through 2017, especially considering the low level of unemployment. Employees may not be pressing for higher wages, but they will likely be getting them soon. Services constitute about 68% of U.S. personal consumption and have a 63.75% weight in the CPI. While the CPI attempts to capture consumer consumption patterns through its surveys, people have been shifting their spending toward services for years. Key features of most services include limited price transparency, high labor content, and minimal jurisdictional mobility. Not surprisingly, service inflation exceeds goods inflation.

The graph on the next page shows the challenge workers face as wages, reflected by the Employment Cost Index (ECI), have barely kept up with services inflation. For the older generations who have entered the high medical care consumption years, the burden has become more problematic. Some aspirational items like college tuition, certain forms

of entertainment, and food away from home have comfortably exceeded reported inflation. It is surprising that wage pressures have not been more severe. In our 1Q 2017 Commentary, we discussed the unemployment rate and suggested labor market pressure may be more acute than the reported jobless rate indicated. We also cited a Federal Reserve Bank of Cleveland study that argued the Natural Rate of Unemployment should be between 5% and 6%. On October 6, 2017, the Bureau of Labor Statistics reported an unemployment rate of 4.2%. While October's number may have been distorted by the hurricanes, it is not meaningfully away from the lowest level of unemployment in the last 30 years, 3.8% in April 2000. Many small businesses like home repair services, construction, landscaping and others have struggled to find labor. Some shortages may be attributable to reduced immigration, but the larger challenge for the economy, comes from the absence of slack at a time of accelerating growth.



Source: Bureau of Labor Statistics

Analysis by Pantheon Macroeconomics shows that beginning around 2014, the increase in average hourly earnings lagged the increase in National Federation of Independent Business' (NFIB) index of unfilled job openings, advanced by nine months. That relationship had been tight since 2000. The NFIB also publishes a Small Business Optimism Index that rose after the presidential election and has remained elevated. This combination suggests small business' demand for labor will continue and even become more intense as the global macroeconomic picture improves. Any additional lift from growth oriented tax policy could make labor shortages worse, likely leading to wage pressures and higher prices.

Since the 2008 financial crisis, economic analysis, market discussions, and investment strategy considerations have involved pre and post 2008 comparisons because of the depth of the recession and the extraordinary actions of the world's central banks. Analogous to recovery from a severe injury, almost ten years after the crisis, the world appears to have the strength to stand unaided, and the therapy now runs the risk of becoming excessive. In a world of synchronous growth, supply and demand driven forces on commodities and labor should logically lean toward higher prices. Technology has done wonders for efficiency, cost reductions, and changes in consumer behavior, but it cannot fundamentally alter the laws of economics. As wage pressures build, inflation will surely be close behind.

October 15, 2017

Sources: Bureau of Labor Statistics, Pantheon Macroeconomics, National Federation of Independent Business (NFIB), and Federal Reserve Bank of Cleveland

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.