GIA PARTNERS

2nd Quarter 2014

Highlights

- After a weak first quarter, rebounding economic data propelled equity and credit markets in the second. Our portfolios outperformed, mostly due to a recovery in emerging markets;
- Revisions to first quarter GDP showed it was the worst since 2009. Data recovered in the second quarter, but now questions about sustainability are appearing;
- Long term interest rates declined during the quarter despite indicators the reverse should have happened. We believe technical factors were the cause.

Markets

		Returns (%)	
GIA*	Average Quality	2Q14	12 Months
Global High Yield Composite	(B+)	3.64	12.10
Global Credit Plus Composite	(BBB-)	3.75	10.82
Core Plus Composite	(A-)	2.75	6.99
Emerging Market Debt Composite†	(BB+)	4.69	N/A

**Returns are net of fees*

Benchmark Bonds			
Barclay's U.S. Aggregate Index	(AA+)	2.04	4.37
Treasury	(AAA)	1.35	2.04
Credit	(A)	2.71	7.44
Mortgage	(AAA)	2.44	4.71
Government/Credit	(AA)	1.92	4.28
BoA Merrill U.S. Corps & Yankees	(A)	2.79	7.46
BoA Merrill Corporate Master	(A-)	2.89	7.98
BoA Merrill High Yield	(B+)	2.49	11.71
JPM Emerging Markets EMBI+	(BBB-)	5.81	10.73
JPM CEMBI Broad	(BBB)	3.80	9.54
JPM GBI-EM Global Diversified	(BBB+)	4.02	3.91
Citi Non-U.S. World Govt. Bonds	(AA-)	2.64	8.88

Benchmark Equities			
S&P 500	NA	4.69	22.04
Nasdaq Composite	NA	4.98	29.53
Russell 2000	NA	1.70	22.05
MSCI EAFE	NA	2.95	20.33
Europe	NA	1.90	25.87
Japan	NA	6.48	7.94
MSCI Emerging Markets Equity	NA	5.64	11.75

Markets

Financial markets, driven by U.S. equities, spent the second quarter of 2014 looking for direction. Most of the search focused on the trajectory of the economy as the weather-related drag on the first quarter became more apparent. The eventual easing of tensions in Ukraine and encouraging policy actions from the European Central Bank provided enough optimism to lift global equity markets and support "risk on" trades. In a twist, longer term interest rates declined, surprising many investors who expected long term rates to rise as the Federal Reserve curtailed its U.S. treasury and mortgage purchases. These interest rate moves appear to have been driven by capital flows, rather than by indicators the economy was faltering.

High yield bonds had another solid quarter supported by robust fundamentals and an assist from lower interest rates. In addition, inflows continued into high yield bond funds, although leveraged loan funds saw withdrawals during the quarter. The Bank of America Merrill Lynch High Yield Cash Pay Index (J0A0) was up 2.49% for the quarter. Spreads narrowed from 379 b.p. to 363 b.p., and the yield to worst declined from 5.14% to 4.89%. Mutual fund investors added $3.7 billion to high yield funds during the quarter for a year-to-date inflow of $7.1 billion, and a dramatic shift from last year's $14.2 billion first half outflow. The default rate rose sharply during the quarter to 2.06% compared to 0.61% at the end of March due mostly to the former Texas Utilities' April default. Excluding TXU's default, the default rate was a modest 0.70%. During the quarter new issues totaled $121 billion, which brought year-to-date volume to $209 billion, close to last year's first half at $219 billion.

The Bank of America Merrill Lynch U.S. Corporate Index (C0A0) delivered strong results for the quarter, driven primarily by a move lower in longer-term interest rates. The Index was up 2.89% for the quarter, while the Bank of America Merrill Lynch U.S. Treasury Index was up 1.56%. Investment grade corporate spreads narrowed by 16 b.p. to 101 b.p., and the yield to worst of the index decreased from 3.13% to 2.94%. Issuance for the quarter continued at a robust pace reaching $291.7 billion, bringing the year-to-date total to $645.6 billion. New issuance during last year's first half was $585.4 billion a bit less than half of 2013's record $1.1 trillion in investment grade issuance.

Emerging markets debt had a strong quarter after the Ukraine/Russia conflict eased and Ukraine had a successful presidential election. Inflows returned to emerging markets both in bonds and equities likely because investors perceived valuations to be attractive relative to developed markets, and diminishing volatility encouraged risk-taking. The best performing segment was dollar-denominated sovereign debt followed by local markets and corporate debt. The J.P. Morgan Emerging Markets Bond Index Plus (EMBI+), a dollar denominated sovereign index was up 5.81% for the quarter, the JPM Corporate Emerging Markets Broad Index (CEMBI Broad) returned 3.80% for the quarter, and the JPM Global Bond Index – Emerging Markets Global Diversified (GBI-EM Global Diversified), a local markets index, returned 4.02%. Year-to-date those markets returned 9.47%, 6.25%, and 5.99% respectively.

Portfolios

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 115 basis points, net of fees, in the quarter, and was ahead of the index by 39 basis points over the last 12 months. During the quarter and the last 12 months, the Composite held a meaningful exposure to emerging markets based on relative value. Emerging markets corporate bonds recovered during the quarter after Ukraine held

successful presidential elections and the stand-off with Russia eased. In addition, emerging market fund flows, which had been negative, reversed and helped generate demand for the entire sector. Our high yield holdings continued to outperform the high yield index further contributing to excess returns. Over the last 12 months, emerging markets underperformed high yield. Our security selection added enough in relative performance to overcome the drag from the emerging markets allocation and generate some outperformance.

Our *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 99 basis points during the quarter and was ahead by 172 basis points over the last 12 months. The portfolios had an allocation of approximately 37% U.S. investment grade, 25% high yield, and 38% emerging markets, mostly investment grade rated. During the quarter, the best performing markets were emerging markets and investment grade credit. The portfolio's exposure to emerging markets generated most of the outperformance as that sector recovered from its underperformance in the first quarter of the year. High yield and investment grade securities in the portfolios outperformed their respective indexes adding to the Composite's relative outperformance. During the last 12 months the Composite benefited from the portfolio's exposure to high yield and emerging markets, while being underweight investment grade credit. Our security selection was favorable across all sectors.

Our *Core Plus Composite* consists of portfolios that can hold up to 30% in securities rated below investment grade. The Composite outperformed the Barclays U.S. Aggregate Index, net of fees, by 71 basis points for the quarter, and was ahead by 262 basis points over the last twelve months. During the quarter, the portfolio was underweight mortgages and treasuries and overweight credit, including high yield and emerging markets. The portfolio's exposure to credit in general and emerging markets in particular, helped generate excess returns during the first quarter and the last 12 months. Over the last 12 months, the portfolio's underweight to mortgages and treasuries also proved to be helpful as rates increased causing treasuries to deliver modest returns.

Our *Emerging Markets Debt Composite*[†] consists of portfolios investing in dollar denominated emerging market credit securities, primarily from corporate issuers. The Composite is measured against the J.P. Morgan Corporate Emerging Markets Bond Index – Broad (CEMBI-Broad). The EM Debt Composite only has one quarter of performance. During the quarter the portfolio outperformed the benchmark by 70 basis points, net of fees. The portfolio had overweight exposures to both Russia and Ukraine and benefited from the peaceful developments in the conflict between the two countries. In addition, the portfolio had higher exposure to securities rated below investment grade which benefited from the overall improvement in emerging markets.

Economy

The real economic news appeared in the revisions as, it turns out, the first quarter of 2014 was the worst quarter since 2009, coming in at -2.9% instead of the originally reported 0.1%. Most of the contraction was attributed to weather and the second quarter appears to have been the beneficiary of make-up activity. There are still many reasons for optimism and economists raised the 2Q forecasts to an average of 3.5% from below 3.0% in March. However, looking forward many question the momentum and sustainability of growth. Average forecasts remain at 3.0% for the second half, but global events may dent the ultimate growth rate.

Domestically, we think there are still reasons for optimism. Auto sales remain strong reaching 2006 annualized levels. Some concern exists as subprime buyers make up a larger share of purchases, but the average fleet age remains

elevated. Corporate earnings continued to beat expectations in the first quarter and busy mergers and acquisitions activity suggests business investment is healthier. Furthermore, manufacturing activity remains robust and the June employment report led many economists to move forward their timing expectations for rate hikes from the Fed. While consumers have shown some stinginess this year, household leverage is still well below pre-recession levels.

Overseas the outlook is not as rosy. After an unsettling stand-off between Ukraine and Russia, developments in the Middle East pushed oil prices higher and raised the specter of long term violence. The Israel/Palestine conflict resumed, indicating no progress has been made after years of negotiation. In addition, the European Central Bank was forced to expand its credit facilities to encourage more lending and help banks meet stricter capital requirements. In Japan the government's policies succeeded in weakening the Yen, but have not had enough structural depth to broaden growth.

Emerging markets have shown mixed performance, as expected, with positive surprises in India and negative surprises in Brazil. Growth in China has improved, but at a slow pace suggesting the country's marginal contribution to global growth will be modest this year. While there is meaningful variance between countries, the outlook for emerging economies has improved after last year's funding fears disrupted markets. Fund flows have returned in 2014 and even equity markets are showing resilience.

We remain optimistic on the U.S. economy and continue to believe it is in better shape than most other countries and stronger than many observers believe. However, our enthusiasm has been slightly dampened by global events and the absence of a coordinated move higher in certain indicators.

Scenarios

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

1. Our most likely case has the economy growing 2.5% to 3.0% in 3Q 2014 and 4Q 2014. We believe the economy's underlying strength remains in place, and the first quarter drag will be made up in the second half. The Fed's ongoing taper is good news for the economy through expanded bank lending. Recent employment data have confirmed some of our optimism with the unemployment rate down to 6.1%, the level the Fed cited a few years ago as an important threshold. While we expect limited support from abroad, monetary policy in Europe and Japan remains stimulative and some emerging economies have shifted from restraint to stimulus. PROBABILITY 70%

2. A second scenario has the economy recovering to above-trend growth of 3.5% to 4.0% over the next six months. We believe the U.S. economy enjoys many favorable factors which could support a faster rate of growth if they could be complemented with supportive government policy measures and improvement in global activity. With better results from Europe and Japan global economic performance could surprise on the upside. PROBABILITY 15%

3. A third scenario has the economy declining to a 0.5% to 1.5% growth rate due to a crack in business and consumer confidence. Higher oil prices may persist with expanding Middle Eastern violence, leading to higher prices and moderate growth in consumption. If poor conditions in Europe and many emerging economies persist, U.S. exports may stall, dragging down the economy's net trade balance. In this scenario, the economy's momentum could be snapped, taking activity back into a lethargic phase. PROBABILITY 15%

Market Outlook

U.S. equity indexes closed at record highs in June, economists boosted their second quarter forecasts, and the unemployment rate was reported at 6.1% on July 3, 2014. All of these would be suggestive of an economy on the mend after the severe recession of 2008-2009. However, in the face of these strong indicators, long-term interest rates declined. We believe this inconsistency has been due to technical factors affecting the U.S. treasury market. With a robust fundamental environment supporting credit markets, we believe the biggest risk remains a move higher in interest rates. The factors affecting the U.S. treasury market include foreign flows and macro risk positioning. Should both of these reverse, it is likely long term interest rates will move higher, reversing some of the year's bond market gains and cooling positive bond fund flows. While we do not expect crisis conditions, we believe higher rates will dampen enthusiasm in bond markets.

Commentary – Why are Long Term Rates Falling?

At year-end 2013 ten year U.S. treasuries yielded 3.03% and long bonds yielded 3.97%. As of June 30, 2014 the 10-year was 2.53% and the long bond was 3.36%. By contrast the 5-year went from 1.74% to 1.63% and the 2 year from 0.38% to 0.46%. Meanwhile, the S&P 500 equity index returned 6.05% over the same time period, a reasonable sequel to the near 30% return in 2013. One of the most widely held views among investors as 2013 ended was that U. S. interest rates would rise. How did long term interest rates do the opposite in the face of rising stock markets?

The first, and simplest, reason may well be that the consensus on rising rates was so widely held. We noted in our fourth quarter 2013 commentary that, on average, economists in their December 2013 WSJ Economic Survey expected 10-year rates to be 3.47% by year-end 2014. They also forecast inflation of approximately 2.0%. (Through May 2014 the Consumer Price Index (CPI) was running at a 2.5% annual pace.) We now know the economy had an abysmal first quarter in 2014, but the awful data showed up in revisions, not in the original GDP release. Traders saw the original data releases, but market prices did not react as though the information would be as bad as it ultimately was.

Even the Federal Reserve (Fed), which started curtailing its quantitative easing (QE) at its December meeting by withdrawing $10 billion of bond purchases, did not suspend its withdrawals during the first quarter as the data surfaced. In fact, the Fed reduced bond purchases at every meeting this year, and has cut its pace of buying from $85 billion per month to $35 billion starting in July 2014. Not only has the Fed curtailed its efforts to keep long rates down, many economists and bond strategists moved forward their expectations for the Fed to raise short term rates on the heels of robust economic data during the second quarter, especially June's employment report. With the Fed loosening its grip on lower rates and bond watchers looking for higher rates, how did longer term rates go down?

The data is not yet conclusive, but there are reasonable indicators that three significant factors, all technical, came together to offset the Fed's withdrawal and push long term yields lower during the first half of the year.

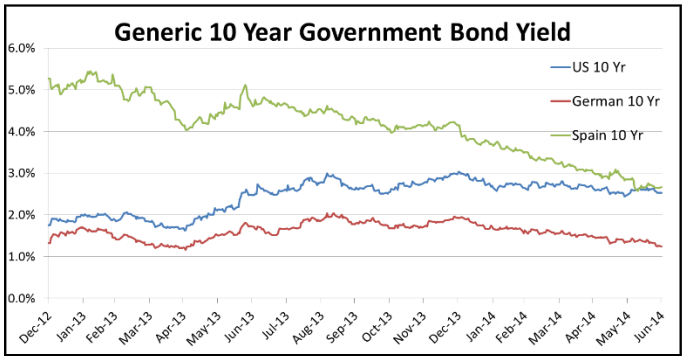
- Retail investors did not listen to the strategists;
- Global bond players favored U.S. treasuries;
- Some professional investors went short.

According to J.P. Morgan, retail investors altered their allocations significantly in the first quarter of 2014. Investors went from selling bond funds in the second half of 2013 to buying them in the first quarter of 2014. The report mentions "The annualized pace of bond fund buying is $360 bn YTD, up from total buying of $185 bn of bond funds in 2013."[1] Recognizing that flow data is obtained with a lag, it seems reasonable to expect investors to "take some equity chips off

[1] J.P. Morgan "Flows and Liquidity" June 6, 2014.

the table" after last year's stellar performance. The surprise is that bond funds were the beneficiaries of inflows at a time when expectations for higher rates were so prevalent. Money market funds, which would be the most risk averse choice, continued to experience outflows.

Another argument for the move lower in long term rates is that foreign government bond buyers shifted their allocations from selling U.S. in favor of Europe during 2013, to buying U.S. and selling both Europe and Japan. The graph below illustrates the evolution of 10-year interest rates for the U.S., Germany and Spain. On December 31, 2012 the 10 year yield differential between the U.S. and Germany was about 50 basis points. By December 31, 2013 the differential was 110 b.p. More starkly, the yield benefit from investing in a "high risk" European government, like Spain, went from 351 b.p. at the end of 2012 to zero on June 11, 2014. With the European Central Bank in the middle of another easing program, which could keep rates low and perhaps pressure the Euro, it seems logical to favor a higher yielding and relatively stable market, like the U.S. Flow of funds data confirms that foreign banks slowed their pace of U.S. selling substantially between 4Q 2013 and 1Q 2014, while official institutions increased their purchases.



Finally, many professional investors positioned themselves against rising U.S. interest rates by going outright short, or by shortening the duration of bond portfolios. In a highly discussed article, Bloomberg's Liz Capo McCormick wrote about fails in the repo markets.[2] Repos, or Repurchase Agreements, are arrangements between two parties, generally banks, money market funds, active traders, and other highly liquid institutions whereby the party in need of funds sells securities (generally U.S. treasuries) to the party with funds with an agreement to repurchase the securities at an agreed time. These transactions are effectively very high quality short term loans. Fails occur when there is a shortage of bonds to deliver for repo transactions. Sizeable short positions can cause fails as demand for securities may exceed the amount of securities available to settle trades, thereby causing the fails. The article discusses fails in certain 5 and 10 year U.S. treasury securities. The 10 year treasury is a benchmark for many transactions in bond markets, so fails are not proof of short positions. However, fails are indicators that there is deficiency of collateral suggesting many players are either selling short or trying to hedge their interest rate exposure.

It is feasible that long term U.S. rates are discounting disappointing future growth or lower inflation. If this is true, why did short term rates rise as long term rates declined? And why has the Fed continued on its tightening course? It is unusual that one of the largest securities markets in the world, the U.S. treasury market, might be caught in a "technical" trade. However, when consensus becomes overwhelming, even that market cannot step aside.

July 14, 2014

† Please note net returns for the Emerging Markets Debt Composite have been recalculated from February 2014 to June 2014 to reflect management fees at 0.75 percent.

[2] "Bond Anxiety in $1.6 Trillion Repo Market as Failures Soar," July 7, 2014, Liz Capo McCormick (Bloomberg)

GIPS requires GIPS Disclosure Statement (please see attached disclosure)
GIPS requires GIA fee schedule disclosure "GIA's fees are (i) .35% annually for standard USA fixed income, (ii) .50% annually for enhanced fixed income and (iii) .75% annually for specialized products"

Important Information

GIA Partners, LLC ("GIA") is an SEC registered investment adviser.

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Forecasts and Market Outlook: The forecasts and market outlook presented in this material reflect subjective judgments and assumptions of the investment manager and unexpected events may occur. There can be no assurance that developments will transpire as forecasted in this material.

Management Fees, as well as account minimums and other important information are described in GIA's Form ADV - Part IIA. Since management fees are deducted quarterly, the compounding effect will be to increase the impact of such fees by an amount directly related to the account's performance. For example, an account with a 10% gross annual return and a 1% annualized management fee that is deducted quarterly will have a net annual return of about 8.9%.

*Important GIPS disclosures pertaining to composite performance may be found at the back of this letter.

Index Definitions

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.

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.

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.

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.

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.

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.

Citigroup Non-US World Government Bond Index
The Index is comprised of foreign government bonds with maturities over one year.

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.