GIA PARTNERS

2nd Quarter 2018

Highlights

- Financial markets remained beholden to geopolitical drama and trade rhetoric. Interest rates moved higher, the yield curve flattened further and credit spreads widened, especially in emerging markets;
- Data suggests the U.S. economy grew strongly in the 2Q and momentum should help deliver a good second half of 2018. By quarter end, the outlook was improving in Europe and China;
- Emerging market bonds succumbed to the "strong dollar – weak emerging markets" narrative. In our opinion spread widening in corporate bonds does not appear warranted by the fundamentals.

Markets

		Returns (%)			
GIA*	Average Quality	2Q18 Gross	2Q18 Net	12 Months Gross	12 Months Net
Core Plus Composite	**(A)**	**-0.47**	**-0.56**	**0.21**	**-0.15**
Global Credit Plus Composite	**(BBB+)**	**-0.45**	**-0.58**	**-0.09**	**-0.59**
Emerging Market Debt Composite	**(BB+)**	**-2.97**	**-3.15**	**0.79**	**-0.03**
Benchmark Bonds					
Bloomberg Barclay's U.S. Agg. Index	(AA+)	-0.16		-0.40	
Treasury	(AAA)	0.10		-0.65	
Credit	(A)	-0.88		-0.65	
Mortgage	(AAA)	0.24		0.15	
Government/Credit	(AA)	-0.33		-0.63	
ICE BofAML U.S. Corporate & Yankees	(A-)	-0.84		-0.65	
ICE BofAML U.S. Corporate	(A-)	-0.94		-0.70	
ICE BofAML U.S. Cash Pay High Yield	(B+)	1.00		2.49	
ICE BofAML EM Corporate Plus	(BBB)	-1.64		-0.20	
ICE BofAML Global Gov't ex-US	(AA-)	-0.22		1.48	
JPM Emerging Markets EMBI+	(BB+)	-4.14		-4.31	
JPM CEMBI Broad	(BBB-)	-1.79		0.10	
JPM GBI-EM Global Diversified	(BBB)	-10.40		-2.33	
Benchmark Equities					
S&P 500	NA	2.93		12.17	
Nasdaq Composite	NA	6.33		22.31	
Russell 2000	NA	7.43		16.09	
MSCI EAFE	NA	-2.34		4.01	
Europe	NA	-2.74		2.37	
Japan	NA	-3.01		8.49	
MSCI Emerging Markets Equity	NA	-8.66		22.17	

Markets

A fitting characterization for the second quarter is "go – no go." Maybe inspired by the "on again," "off again" summit between President Trump and Kim Jong Un and escalating rhetoric on trade wars, financial markets oscillated in search of direction. As telegraphed, the Federal Reserve raised rates in June, but fittingly, left the market debating the "three hikes – four hikes" 2018 conundrum. U.S. equity markets traded in narrow ranges, ultimately delivering gains for the quarter. Bond yields moved mostly higher, but the yield curve flattened further with the 2-year - 10-year slope declining from 47 basis points to 33 b.p. and the long end remaining surprisingly well bid. Credit spreads widened, but the quarter's most visible casualty was emerging markets where a vicious cycle narrative took hold. The narrative argues a strong dollar and rising interest rates threatens emerging economies because dollar obligations become harder to service. By mid-quarter, investors fled EM stocks and bonds leading to further devaluations and dismal USD returns. Not to be left out, Italy had an inconclusive election and a "go – no go" government that caused a brief market melt-down and reignited commentary on the survivability of the Euro. In the end, after a litany of events and lots of head-scratching, many equity and bond markets were little changed. The U.S. economy likely posted a very strong quarter and continues to lead global growth. For now, this has sufficed to push the U.S. dollar higher and alter expectations in emerging economies where, contrary to the pessimistic narrative, a strong dollar may help stimulate exports.

The investment grade corporate bond index, the Bank of America Merrill Lynch U.S. Corporate Index (C0A0), was down (0.94%) for the quarter and was down (3.12%) year to date. Credit spreads widened driven by reduced fund flows and a still-robust new issue pipeline. Widening in the short end ceased as corporations completed their cash repatriation. During the quarter, the U.S. treasury index returned a modest 0.11% as coupon income offset marginally higher rates and a flatter yield curve. For the first half, treasuries declined (1.10%) a modest amount considering 2-year treasury yields increased 61 b.p. and the Fed raised rates by 50 b.p. Corporate option adjusted spreads (OAS) widened by 12 b.p. to 130 b.p., while the yield to worst of the index rose from 3.77% to 4.07%. Issuance for the quarter at $338.9 billion was below the $393.8 billion of the first quarter, but together, new borrowing set a pace that can tie or exceed last year's record $1.47 trillion total.

High yield bonds performed surprisingly well considering retail investors continued to withdraw money and spreads were widening in both investment grade and emerging markets credit. The Bank of America Merrill Lynch High Yield Cash Pay Index (J0A0) returned 1.00% for the quarter and was up 0.06% year to date. Spreads to worst narrowed by 5 b.p. from 385 b.p. to 380 b.p., while the yield to worst increased from 6.35% to 6.50%. Retail investors withdrew another $3.85 billion in 2Q, marking eight out of nine months of outflows and a year to date withdrawal of $23.7 billion. The default rate decreased to 1.98% in June from 2.21% in March, and, unusually, included a zero default month in June. New issuance for the quarter totaled $53.5 billion and $126.3 billion year to date, 28% lower than last year's first half. Issuance in the leveraged finance space shifted toward loans as investors pursued floating rate alternatives to capture rising interest rates.

Emerging markets bonds had a challenging quarter as investors acquiesced to the strong dollar – weak emerging markets narrative. Entering 2018, many were overweight countries like Argentina, Brazil and Turkey on the back of improving fundamentals and global growth optimism. As the downside narrative took hold and investors accelerated fund withdrawals, each country experienced damaging domestic events that exacerbated investor concern. In Brazil, a crippling truckers' strike paralyzed the economy, and in Turkey a contested election exposed deficiencies in economic policy. Both of these, likely manageable over the longer term, did nothing to appease investors in 2Q. For the quarter, the JPM Emerging Markets Bond Index Plus (EMBI+), a dollar denominated sovereign index, was down (4.14%), the JPM Corporate Emerging Markets Broad Index (CEMBI Broad) declined (1.79%), and the JPM Global Bond Index – Emerging Markets Global Diversified (GBI-EM Global Diversified), a local markets index, lost (10.40%). Year to date these markets declined (6.09%), (2.82%), and (6.44%) respectively. For the local markets index, the year to date currency effect was a negative (6.44%).

Portfolios

Our *Core Plus Composite* consists of portfolios that can hold securities rated below investment grade, but are managed against a Core fixed income benchmark. The Composite underperformed the Bloomberg Barclays U.S. Aggregate Index, net of fees, by 40 b.p. for the quarter, but was ahead by 25 b.p. over the last twelve months. During the quarter, interest rates rose further and the yield curve flattened, but treasuries and mortgages managed modest positive gains. Investment grade and emerging market corporate underperformed, with emerging markets delivering the worst results. Portfolios were underweight mortgages and government bonds, and overweight emerging markets leading to underperformance for the quarter. Over the last 12 months, higher yielding credit sectors outperformed despite rising interest rates and a flattening yield curve. The Composite's outperformance came primarily from exposure to high yield and emerging markets, with an additional contribution from an underweight to government bonds.

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 ICE BofAML U.S. Corporate and Yankees and 15% of the ICE BofAML U.S. Cash Pay High Yield Index. The Composite underperformed the benchmark, net of fees, by 2 b.p. during the quarter, and was behind by 41 b.p. over the last twelve months. The portfolios had an allocation of approximately 61.3% U.S. investment grade, 12.1% high yield, and 12.6% emerging markets, of which 1.1% was investment grade rated. The best performing sector during the second quarter was high yield, while the worst was emerging markets. The portfolio was underweight high yield, and overweight emerging markets, both of which detracted. Outperformance in investment grade credit provided a slight offset. Over the last twelve months, the portfolio's underweight to below investment grade rated securities was responsible for most of the underperformance.

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 ICE BofAML U.S. Emerging Markets Corporate Plus Index (EMUB). During the quarter the portfolio underperformed the benchmark by 151 b.p., net of fees, and by 1 b.p. over the last twelve months. During the quarter, emerging markets had the worst performance in fixed income as investors became concerned about the implications of a stronger U.S. dollar and rising interest rates. In corporate credit, below investment grade rated bonds suffered most, underperforming the index by 160 b.p.. The portfolios had higher exposure to below investment grade rated securities, causing most of the quarterly underperformance. The severity of the below investment grade underperformance in the second quarter eroded the portfolio's outperformance in the prior nine months, leading the portfolio to be essentially flat over the last twelve months.

Economy

Despite noisy trade rhetoric, a strengthening U.S dollar and higher interest rates, the economy likely delivered on the high side of our optimistic scenario in the second quarter. With robust employment, consumers kept spending, and an investment revival helped boost manufacturing to generate a growth rate that may exceed 4.0%. While we do not think this pace will be sustained in 3Q, it suggests the economy has enough momentum to withstand still higher interest rates. The trade war disruptions have not yet impeded consumption and hiring, but may have a deleterious effect on business confidence. A key premise supporting the optimistic outlook is the investment incentive inherent in a lower corporate tax rate. Policy offsets to that incentive may cause companies to postpone investment plans, possibly eroding the growth story.

Economists participating in the WSJ Economic Survey for June raised their 2Q forecast to 3.6% from 3.2% on average. While they did not adjust their 3Q or 2018 full year forecasts, they notched up/down their inflation and unemployment forecasts, suggesting they still expect the economy to perform well through year-end. However, respondents continue to express notable apprehension with nearly 47% believing the risk to their forecasts is to the downside.

Meanwhile corporations appear to be enjoying another year of strong earnings, and, more recently, growth in the top line. Robust cash flow encourages investment and hiring, although many companies report challenges finding adequately

skilled workers. While wage data has not yet shown stress, we believe it is a matter of time before the pressure nudges employment costs higher.

Foreign economies underperformed expectations, although in important regions temporary factors appear to have played a role. In Europe, political factors seem to have curtailed confidence, which began to recover by quarter end. The decline in the Euro should provide stimulus, as it did leading to excellent European performance in the final quarters of 2017. China's softer numbers appear to have been an adjustment to the unsustainable pace recorded last year. Authorities appear to be engineering a more comfortable pace. Finally, Brazil's recovery was interrupted by a crippling truckers' strike. That will lower the country's GDP data, but not likely sever an overdue recovery.

Scenarios

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

1. Our most likely case has the economy growing about 3.0% 3Q and 4Q 2018. Our expectation matches the consensus, although we would place the risk to our outlook to the high side. For now, business and consumer confidence remain elevated with the employment and wage picture looking supportive. We believe the economy's underlying strength enjoys tail winds from further investment, ample financing availability, and improving momentum abroad. The visible constraints to the economy, trade wars and Fed rate hikes, do not yet appear to have traction. We believe the U.S. continues to lead the current global expansion. PROBABILITY 65%

2. A second scenario has the economy improving to above-trend growth of 3.5% over the next six months. With a likely declining unemployment rate and additional tax-driven investment, second quarter momentum may carry into the second half of the year. It is conceivable the trade battles result in more favorable terms for some U.S. exporters, leading to an additional boost from trade. Furthermore, we believe growth abroad will recover in the second half and restore the confidence that existed at the end of 2017. PROBABILITY 20%

3. A third scenario has the economy declining to a 1.75% growth rate. The Administration's strategy to use tariffs and trade threats to correct current account imbalances may back fire, leading to an erosion in global trade and a rapid loss of confidence. In such a scenario, business investment may not materialize and the expected lift in wages and employment may disappear. Furthermore, it is possible the factors that sullied foreign economic activity in the first half of the year may lead to another half year of underperformance. PROBABILITY 15%

Market Outlook

The U.S. economy likely generated excellent growth in 2Q and many economic indicators point to a solid 3Q. A worrisome component involves low unemployment and nascent wage pressures. We believe inflation will likely exceed both the Fed's and the market's expectations forcing the central bank to act more aggressively on rates in 2018. Although favorable technical factors may contain interest rates in the long end of the yield curve, we believe the tendency remains to the upside. Despite this, we do not believe rates will move high enough, or quickly enough, to derail the economy in 2018. Credit remains abundant and businesses will likely continue to invest. Consequently, we believe credit spreads will not widen much more. In addition, we believe global growth will outperform, boosted partly by the stronger U.S. dollar. With this, commodity prices should remain stable and emerging economies should enjoy the benefits of improving exports. We will likely look for opportunities to increase exposure to high quality emerging markets companies to take advantage of excessive pessimism in that sector.

Commentary – Strong Dollar - Weak Emerging Markets?

On May 21, 2018, the Wall Street Journal (WSJ) published an article in the Markets Section titled "Rising Dollar Sparks Tumult in Emerging Markets." The opening sentence was, "A resurgent dollar is exposing weaknesses in the developing world, pushing investors to unwind long-held bets on emerging-market stocks, bonds and currencies.[1]" On May 25, 2018, in the Heard on the Street Section, the WSJ's Richard Barley titled his article, "It's Too Early to Give Up on Emerging Markets." In his article he wrote:

> "The problem for emerging markets right now is mostly about the rising dollar and higher Treasury rates, exacerbated by signs of softening growth outside the U.S. The mind-set for investors has moved from thinking about the opportunities for stronger growth and higher returns to the threat that tighter financial conditions pose.
>
> However, the experience of recent years in emerging markets has led to efforts to reduce vulnerabilities. Current account deficits have narrowed. It seems policy makers remain aware of the risks posed by the global economy, even though emerging market inflation has been mostly well-behaved.[2]"

That was followed by an article titled "Emerging Markets Have a Dollar Problem" in the Journal Reports: Funds & ETFs section on June 3, 2018, and "Emerging-Markets Rout Boosts Contagion Fears" in the Economy section on June 10, 2018. There were many more articles on emerging markets in June as the financial press grappled with the first domino-like sell-off since 2015. Are these concerns justified?

Starting from the "fundamentals" of emerging markets, the answer is a resounding No. As Mr. Barley points out, after living through repeated crises and growth setbacks, many countries adopted prescriptions formulated by entities like the IMF and other development minded institutions. These changes include, among others, independent monetary authorities, budget deficit controls, incentives for growth in domestic capital markets, improvements in transparency, and professional debt management. Economic globalization forced emerging nations to recognize the importance of having competitive economies and markets. A key component of these changes included flexibility in currency management and liberation of capital accounts.

These changes mean that markets (and authorities) can adjust to conditions, including a strong dollar and rising rates. Borrowers without a natural revenue hedge, generally protect themselves against foreign currency fluctuations. Similarly, monetary authorities raise rates to contain currency runs and defuse inflationary pressures, and fiscal authorities modify incentives to retain capital flows. Altogether, mechanisms are in place to help economies protect against worsening financial conditions, particularly at times of global stress.

Prior periods of emerging market weakness in the face of dollar strength were associated with mediocre to poor economic conditions in the rest of the world. In 2008, the U.S. led the world into a deep recession. In late 2011, U.S. government debt was downgraded and the European periphery was in danger of default. In 2014, Russia invaded Ukraine and energy prices began a steep and prolonged decent. In 2015, Europe was in crisis and much of the developing world was in recession. By contrast, in 2018 the world is growing healthily led by the U.S. and rates are rising in a process of normalization after years of developed market subsidization. Conditions are hardly comparable and data on earnings, economic performance and consumer confidence confirm the differences.

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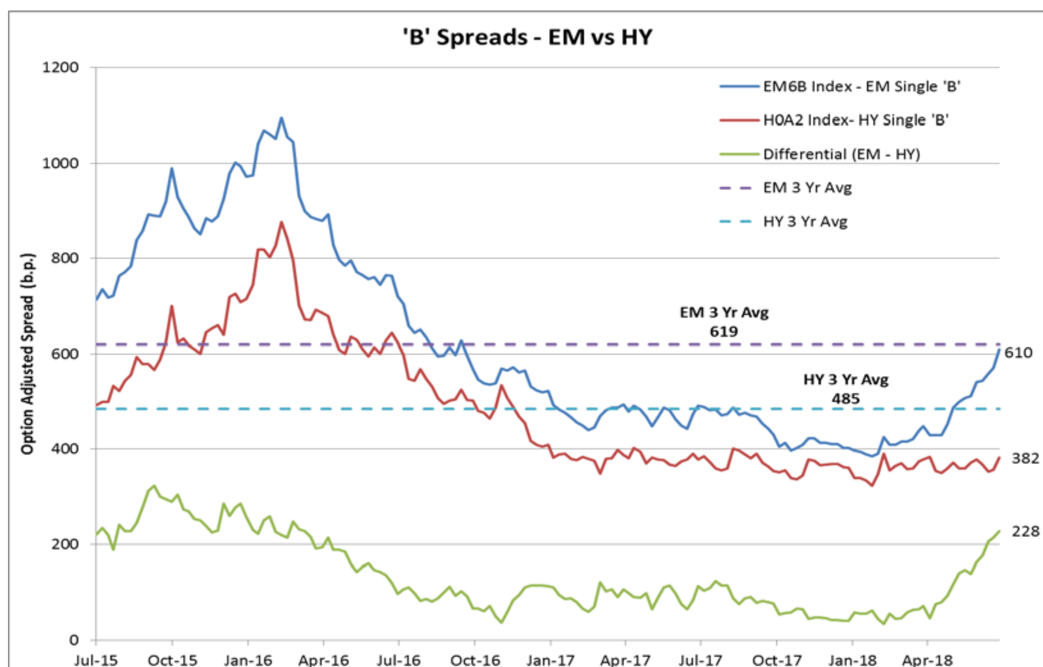
[1] Ira Iosebashvili, Josh Zumbrun and Julie Wernau, "Rising Dollar Sparks Tumult in Emerging Markets," The Wall Street Journal, May 21, 2018

[2] Richard Barley, "It's Too Early to Give Up on Emerging Markets," The Wall Street Journal, May 25, 2018

It may be illustrative to focus on corporate credit, a sector burdened by the poor performance of currencies and sovereign debt. The graph below shows the spread differential between B rated emerging market credits, as reflected by the ICE BAML B rated EM index and B rated U.S. high yield credits. During the second quarter of 2018, the spread widened by 180 basis points. On an absolute basis, emerging markets Bs widened by 182 while high yield Bs widened by 2. The magnitude and speed of the move suggests emerging markets corporations face proximate defaults or meaningful ratings deterioration.



On May 22, 2018, J.P. Morgan published a report titled EM Corporate Fundamentals Checkup, subtitle, "Best year since 2011." The highly complimentary report references 2017 earnings data for its aggregate commentary, including improvements in revenue, EBITDA, debt metrics and outlook. However, a summary bullet point states, "With the bulk of 1Q2018 earnings in hand, we continue to expect a favorable fundamental backdrop for EM corporates in 2018 that is characterized by modest default rates and still improving leverage metrics.[3]" Other points include:

- "We believe top and bottom line gains should improve further in 2018.
- Our expectations include a decline in gross leverage of around -0.2x to 2.5x, a level last seen in 2013.
- The improvement in EM net leverage last year exceeded that for DM IG counterparts, while it modestly lagged on the HY side.
- In HY, EM net leverage moderated -0.1x to 2.7x which was a more modest rate of improvement than in US HY (-0.2x to 3.6x), nevertheless, the absolute levels of net leverage remain significantly lower in EM.[4]"

While the data behind J.P. Morgan's report and comments relate primarily to 2017, we did not see any meaningful deterioration in first quarter 2018 earnings or full year guidance from corporations we follow.

So, what caused a nearly 200 basis point widening in emerging market B rated credit spreads? We believe investors were over-exposed and over-reliant on the global growth narrative as 2018 began. Just as the ebullient U.S. equity market cracked in February, emerging markets cracked in the second quarter. In a July 2, 2018 EM Corporate Weekly Monitor, J.P. Morgan's analysts wrote, "Compared to our 2018 outlook, overall technicals and fundamentals for EM

[3] J.P. Morgan, "EM Corporate Fundamentals Checkup," May 22, 2018
[4] Stet

corporates evolved as we expected but currency volatility has been the main factor driving deviation in performance.[5]" In other words, as a well-known risk factor deviated from expectations, investors recalibrated their entire EM positioning and sold indiscriminately. One-sided trading and poor bond market liquidity exacerbated the price moves. With the global growth picture still looking supportive, and the "shock-absorbing" benefit of flexible currencies helping many emerging economies, we still believe well-managed corporations will deliver good performance in 2018.

July 15, 2018

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[5] J.P. Morgan, EM Corporate Weekly Monitor, July 2, 2018

Important Information

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Index Definitions

Bloomberg Barclays U.S. 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 U.S. 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 U.S .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 U.S. 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 U.S. 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).

ICE BofAML U.S. Corporate & Yankees Index

The ICE BofAML U.S. 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.

ICE BofAML U.S. Corporate Index

The ICE BofAML U.S. 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).

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

ICE BofAML Global Government Excluding the U.S. Index (N0G1)
The ICE BofAML Global Government Excluding the U.S. 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 Broad (CEMBI Broad)
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.