GIA PARTNERS

3rd Quarter 2018

Highlights

- U. S. equity markets hit new records in September, buoyed by the economy and earnings. In fixed income, rates rose further and credit spreads narrowed. Absolute returns remained negative;
- We believe the U.S. economy continued to gain momentum, leading the Fed to raise rates and suggest more tightening is coming. The economy should be strong enough to sustain higher rates;
- We welcome the Fed's efforts to normalize rates. Years of subsidized rates may have caused some asset price distortions, but leverage in the economy should not be a threat this time.

Markets

		Returns (%)			
GIA*	Average Quality	3Q18 Gross	3Q18 Net	12 Months Gross	12 Months Net
Core Plus Composite	**(A)**	**0.52**	**0.43**	**-0.64**	**-1.00**
Global Credit Plus Composite	**(BBB+)**	**0.99**	**0.86**	**-0.50**	**-1.01**
Emerging Market Debt Composite	**(BB+)**	**1.59**	**1.40**	**-1.20**	**-1.94**
Benchmark Bonds					
Bloomberg Barclay's U.S. Agg. Index	(AA+)	0.02		-1.22	
Treasury	(AAA)	-0.59		-1.62	
Credit	(A)	0.89		-1.10	
Mortgage	(AAA)	-0.12		-0.92	
Government/Credit	(AA)	0.06		-1.37	
ICE BofAML U.S. Corporate & Yankees	(A-)	0.94		-1.02	
ICE BofAML U.S. Corporate	(A-)	0.96		-1.10	
ICE BofAML U.S. Cash Pay High Yield	(B+)	2.44		2.89	
ICE BofAML EM Corporate Plus	(BBB)	1.21		-1.12	
ICE BofAML Global Gov't ex-US	(AA-)	-1.07		0.14	
JPM Emerging Markets EMBI+	(BB+)	1.48		-5.01	
JPM CEMBI Broad	(BBB-)	1.24		-0.93	
JPM GBI-EM Global Diversified	(BBB)	-1.83		-7.40	
Benchmark Equities					
S&P 500	NA	7.20		15.66	
Nasdaq Composite	NA	7.14		23.87	
Russell 2000	NA	3.26		13.80	
MSCI EAFE	NA	0.76		-0.01	
Europe	NA	0.39		-3.07	
Japan	NA	2.93		8.17	
MSCI Emerging Markets Equity	NA	-2.02		-3.13	

Markets

If financial markets performance during the third quarter were condensed into a headline, it might read, "U.S. against the world!" During the quarter, U.S. equity indexes reached new all-time highs propelled by earnings and robust economic data, while foreign markets lagged or delivered lower returns in U.S. dollars. Lackluster data in Europe compounded by acrimony over Brexit and policy inertia in Italy kept equity and currency markets under pressure. Japan's equity market performed well, although a weaker Yen faded that performance for U.S. investors. Emerging markets were hit again with new bouts of currency weakness as the "strong dollar – higher rate" narrative was not debunked by better economic data. In fixed income, returns were modest due to higher interest rates. Credit markets outperformed after a poor second quarter as solid earnings and cash flow improved creditworthiness. High yield had notable outperformance as a strong fundamental picture outweighed continuing investor outflows. In other markets, oil moved higher on supply concerns related to Iran while base metals declined in reaction to a stronger U.S. dollar. As we reached quarter-end, interest rates touched new highs for the year and got everyone's attention.

The investment grade corporate bond index, the ICE Bank of America Merrill Lynch U.S. Corporate Index (C0A0), was up 0.96% for the quarter, but was down (2.19%) year to date. Credit spreads narrowed driven by modest reductions in issuance and fund flow gains in intermediate maturity funds. During the quarter, the U.S. treasury index declined (0.66%) taking year to date performance to (1.75%) as interest rates moved higher and the Fed raised the Fed Funds Rate again in September. Corporate option adjusted spreads (OAS) narrowed by 19 b.p. to 111 b.p., while the yield to worst of the index rose slightly from 4.07% to 4.09%. Issuance for the quarter was $272.4 billion the lowest quarterly borrowing in over two years. On current trends, it appears 2018 will not break the issuance record for the seventh consecutive year.

High yield bonds seemed to defy gravity with another impressive quarter despite noticeable worries in emerging markets, continuing withdrawals of funds and higher interest rates in the U.S. The ICE Bank of America Merrill Lynch High Yield Cash Pay Index (J0A0) returned 2.44% for the quarter and was up 2.50% year to date. Spreads to worst narrowed by 49 b.p. from 380 b.p. to 331 b.p., while the yield to worst decreased from 6.50% to 6.19%. Retail investors withdrew another $972 million in 3Q, for a year to date outflow of $25.5 billion. Looking back over twelve months, mutual fund investors have withdrawn $35.2 billion. The default rate increased slightly to 2.02% in September from 1.98% in June, but remains remarkably well-behaved. Excluding the widely expected iHeart Communications default last winter, the default rate has gone from 1.07% to 1.29% since September 2017. New issuance for the quarter totaled $42.1 billion, the lowest quarterly total since the first quarter of 2011. Year to date new issuance was $168.3 billion, 34% lower than last year's pace through nine months of the year.

Emerging markets bonds had a modest recovery during the quarter, although sentiment remained fragile especially in countries that were hard hit during 2Q. While apprehension persisted in countries like Brazil over elections, China over trade wars, Argentina over recession, Turkey over policy and India over the financial system, investors added funds to the asset class. Currencies remained under pressure, but sovereign and corporate hard currency securities saw some recovery. For the quarter, the JPM Emerging Markets Bond Index Plus (EMBI+), a dollar denominated sovereign index, was up 1.48%, the JPM Corporate Emerging Markets Broad Index (CEMBI Broad) returned 1.24%, and the JPM Global Bond Index – Emerging Markets Global Diversified (GBI-EM Global Diversified), a local markets index, lost (1.83%). Year to date these indexes declined (4.70%), (1.62%), and (8.15%) respectively. For the local markets index, the year to date currency effect was a negative (8.36%).

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 outperformed the Bloomberg Barclays U.S. Aggregate Index, net of fees, by 41 b.p. for the quarter and was ahead by 22 b.p. over the last twelve months. During the quarter, interest rates rose further leading treasuries and mortgages to another period of negative returns. Countering weakness in

treasuries, credit spreads narrowed helping investment grade, high yield and emerging markets outperform. Portfolios were underweight mortgages and government bonds, and overweight high yield and emerging markets leading to outperformance for the quarter. Over the last 12 months, the same relative performance held true, especially for high yield. The Composite's outperformance came primarily from exposure to high yield and emerging markets, with an additional contribution from a modestly short-of-index duration exposure.

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 30 b.p. during the quarter, and was behind by 57 b.p. over the last twelve months. The portfolios had an allocation of approximately 74.8% U.S. investment grade, 12.7% high yield, and 9.5% emerging markets, of which 1.1% was below-investment grade rated. The best performing sector during the third quarter was high yield, with emerging markets and investment grade credit behind by nearly 1.5%. The portfolio was underweight high yield, and overweight emerging markets, which did not outperform the benchmark. The portfolio's solid investment grade performance was insufficient to offset the high yield underweight. 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 outperformed the benchmark by 19 b.p., net of fees, but was behind by 82 b.p. over the last twelve months. Emerging markets recovered during the third quarter after facing many challenges in May and June. Some of the concern related to tightening financial conditions dissipated, but did not end. The recovery in countries like Argentina, Turkey and Brazil sufficed to generate quarterly outperformance, but was not enough to overcome the second quarter's underperformance. That underperformance was the source of poor relative return over the last 12 months.

Economy

Economic activity in the U.S. continued at a brisk pace during the summer consolidating an expansion that gained momentum with the reduction in corporate taxes last December. Data on manufacturing and services were near cycle highs by September and measures of business and consumer confidence remained elevated. Perhaps the most notable beneficiary of the expansion has been the labor market. Both measures of labor demand and unemployment suggest the U.S. economy may begin to face labor shortages and wage pressures. The Fed raised rates in September and suggested more hikes are coming, leading long term interest rates to rise at month-end and in early October. After years of complacency in financial markets, investors have begun to assess the implications of higher rates.

Economists participating in the WSJ Economic Survey for September raised their 3Q forecast to 3.2% from 3.0% on average in July. It is interesting to note that in the September 2017 survey, the 2018 growth forecast for 3Q 2018 was 2.4% while the 10-year bond interest rate forecast for year-end 2018 was 3.02% In the September 2018 survey, the growth estimate was adjusted to 3.2% while the interest rate forecast was lifted only 11 b.p. to 3.13%. For 4Q 2018, economists did not change the 2.9% growth level they have had penciled in since March.

Recently, the IMF downgraded its 2018-2019 global growth forecast from 3.9% to 3.7%, citing the realization of various downside risks, including trade wars, Brexit and tighter financial conditions in emerging markets. Certainly, economic data in Europe has disappointed and countries like Brazil, Argentina, India, Indonesia and Turkey suffered setbacks from currency devaluations and other unexpected domestic factors. Despite the hurdles, we believe conditions are propitious for improvement over the coming quarters with commodity prices recovering and the global employment picture looking more supportive.

Our industry reviews show corporations continue to enjoy strong earnings and cash flow. Lower taxes have provided much of the near term lift, but investment data appears to be confirming the longer term benefit of that fiscal action. Interest rate sensitive industries, like housing and autos, are experiencing more modest results, but other manufacturing and services continue to thrive.

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% 4Q 2018 and 1Q 2019. Our expectation falls slightly ahead of consensus in 4Q and meaningfully ahead for 1Q 2019 based primarily on the momentum the economy has as we approach year-end. Despite trade concerns, business and consumer confidence measures remain elevated and labor demand suggests companies continue to find new opportunities. Furthermore, we believe underperformance abroad should reverse in the final quarter and contribute favorably to the domestic outlook. PROBABILITY 65%

2. A second scenario has the economy improving to above-trend growth of 3.5% over the next six months. With the unemployment rate likely declining further and additional tax-driven investment, second and third quarter momentum may carry the economy well above recent historical trends. In addition, with elections completed in Latin America, European budgetary issues resolved, Brexit closer to conclusion and China boosting demand, we believe growth abroad may exceed expectations and help the U.S. economy grow ahead of expectations. PROBABILITY 20%

3. A third scenario has the economy declining to a 1.75% growth rate. Many headwinds identified by the IMF and others may become worse and constrain, rather than support growth. In addition, we may be underestimating the contractionary impact of higher interest rates on the economy. Slower housing and auto sales may dampen the economy's momentum leading to a loss of confidence and subdued consumption. In addition, emerging economies may struggle to recover from the effects of weaker currencies and higher inflation. Altogether, the world would downshift to a slower pace by early 2019. PROBABILITY 15%

Market Outlook

Strong equity market performance in 3Q was, in part, a reflection of the economy's consistently solid performance. By quarter-end, fixed income markets finally endorsed the Fed's likely need to continue to raise rates. We believe the U.S. economy has enough momentum to withstand higher rates along the curve, but investors may begin to reassess valuations in higher risk assets. Separately, economic performance abroad was uneven and many regions faced challenging external factors that may curtail 4Q activity. While we believe conditions remain propitious for improvement in regions like Europe, Latin America and Asia, favorable growth outcomes still depend on the successful execution of growth oriented policies. Given our expectations for improving global growth, we believe interest rates will continue to rise gradually in the U.S. and abroad. While we expect corporate earnings and cash flow to remain strong, valuation levels suggest credit risk exposure should focus on higher quality names and aggregate exposures to higher risk sectors should be pursued opportunistically as valuations improve.

Commentary – About Those Rising Rates

As the third quarter came to a close, interest rates began to rise. The Fed raised the Fed Funds rate on September 26 and subsequently added a bit of hawkish commentary. That, combined with solid economic data, led to a sharp move higher in rates in the final days of September and early days of October. Prior to this move, treasuries flirted with higher rates during the third week in May. The 10-year treasury closed at 3.11% then, but moved lower as the U.S. dollar surged and emerging markets began to weaken. The 10-year traded above 3.11% intraday on September 25 and closed above that level at 3.18% on October 3, 2018. By October 5, the press raised the alarm, "U.S. Government 10-Year Notes Yields Climb to Seven-Year High" was the Wall Street Journal's headline followed by, "Strong economic data reduce the demand for safety of Treasurys" as a subtitle. We say Bravo!

We have been calling for the normalization of interest rates since 2013 when we wrote a commentary criticizing the economic distortions rate subsidies could thrust on the economy. In that commentary we wrote, "We believe the U.S. economy is robust enough to stand on its own. Despite the severity of the recession, the Fed's actions may now be creating more distortions than producing the Fed-mandated results. The longer the Fed maintains its interest rate subsidies, the harder the withdrawal will become. For now, a move higher in interest rates to a level that is still low by historical measures, seems like a reasonable market reaction. As more markets get distorted by subsidized rates, more unexpected reactions will accompany the eventual withdrawal. The Fed should avoid making unprecedented policy actions a standard part of its arsenal." On December 31, 2013, the 10-year treasury closed at 3.03% while the long bond reached 3.97%, both the highest levels of the year.

Observers may applaud the Fed's restraint in late 2013 as subsequent external factors, including a war between Russia and Ukraine, the collapse in oil prices and a deep crisis in the European periphery held back global growth. In hindsight, the U.S. economy was recovering in 2013, but perhaps not robustly enough to carry the world. Now, improvements in global growth are more reliably led by the robust U.S. economy. Citing our 2013 letter, "…a move higher in interest rates to a level that is still low by historical measures, seems like a reasonable market reaction." In this respect, we commend the Fed's more aggressive posture and the move higher in rates, not because we like high rates, but because we would like to see entirely market determined rates along the yield curve. As we noted before, absent the extraordinary policy measures that gave us inordinately low interest rates for years, investors would be astonished by a 3.2% 10-year treasury in an economy with 3+% real growth, a 3.7% unemployment rate and a 2.3% inflation rate.

Evidence of damage wrought on people, assets and businesses as a consequence of enduring uneconomic subsidies abounds. In New York, everyone criticizes the condition of rent-stabilized apartments, in Venezuela, the oil sector has deteriorated steadily due to underinvestment, in economies with socialized/subsidized medicine, patients form lines for treatment, and in subsidized rate economies, asset valuations can get highly distorted. After 2008's financial market debacle, most defined benefit pension plans in the U.S. became woefully underfunded. While many analysts pointed to the decline in asset prices as the culprit, the more consequential source of the problem was the extreme reduction in interest rates used to calculate the value of each pension fund's obligations. For nearly a decade, state, municipal and even corporate plans have been forced to calculate the value of their obligations to beneficiaries using excessively low rates. This has led many pension officials to divert resources for plan replenishment, take more investment risk to reach assumed rates of return or cut benefit payments.

In another example, corporations issued record amounts of debt in the public markets for 6 consecutive years. Analysts and the media frequently fret about the coming reckoning after illustrating their commentary with debt growth graphs. We

often wonder whether writers see the logic for corporate treasuries to avail themselves of inexpensive debt when rates are being effectively subsidized by the central bank. Surely, in deciding to pursue quantitative easing, the Fed wanted consumers to purchase homes, investors to take more risk and corporations to borrow for capital investment. When the subsidies extend over a decade, it should not be a surprise to see economic actors taking the actions, sometimes unintended, that the purveyors of the subsidy seek.

It makes sense to briefly review the implications of a move higher in rates at this time. In early February 2018, U.S. equity markets experienced a correction that included the two largest single day point losses on record. During January, interest rates climbed steadily with the 10-year rate moving higher by 30 basis points. The 10-year rate increased 32 basis points between August 31 and October 3. We are not forecasting, nor do we believe there should be another equity correction, but if, and as, rates move higher over the coming months it is reasonable to expect reactions in markets and the economy. Fortunately, from a macro perspective, it appears the economy is robust enough to withstand the increase as major sectors do not seem to be over-levered.

According to the Federal Reserve, the U.S. household Debt Service Ratio (DSR) came to 9.84% as of the second quarter of 2018. The ratio was split into 4.24% for mortgage obligations and 5.60% for other debt service obligations (credit cards, personal loans, student loans and the like). The DSR measures how much households spend, as a fraction of their disposable income on debt-related obligations. The Fed also provides an estimate for consumer payments that could be considered proximate to debt payments, like monthly rent, insurance, auto leases and property taxes. Altogether, these are called the Financial Obligations Ratio (FOR), which totaled 15.31% as of June 30, 2018. As a comparison, on June 30, 2007, the FOR was 17.83%, the DSR was 12.96% and the unemployment rate was 4.6%. Current indicators do not suggest consumers are overly levered nor imminently at risk should rates continue their gradual ascent.

The U.S.'s most indebted entity is the federal government. According to the Treasury Department, the government has approximately $15.8 trillion in public debt. Given the budget's annual outlay for interest, it would appear the government's average borrowing cost is about 3.31%. Interest payments constitute 12.4% of the annual budget, a sizeable share, but manageable at higher rates. Separately, measured by the Bloomberg Barclays Municipal Bond Index, states and municipalities have about $1.5 trillion in debt. With the benefit of tax deductibility, we do not believe the municipal market faces meaningful stress from higher rates.

Finally, it is challenging to compute U.S. business' aggregate debt and annual interest costs. Using indexes and Fed data, a reasonable estimate of total debt is $13.4 trillion.[1] While aggregate debt levels have increased, credit metrics have not deteriorated meaningfully because earnings have improved. Certainly, credit spreads and default data suggest higher rates will not likely uncover hidden leverage. In a recent Bloomberg News article about risk in the corporate bond market related to M&A related issuance, the authors reference the $5.1 trillion investment grade corporate bond market. Citing the large share of BBB rated bonds in the index, the article worries companies promising debt reduction may be challenged in a slower economy or if business expectations falter. In particular, companies receiving ratings leeway from the agencies after large M&A transactions may be downgraded below investment grade. Indeed this is a risk, but more likely, companies will manage their debt levels to optimize their cost of capital while taking advantage of a stronger economy.

[1] Sources: Federal Reserve, ICE BAML Index Data

In summary, a macro-economic review does not reveal excesses of leverage across broad sectors of the economy. However, it remains likely some borrowers and industries will be adversely affected by higher rates, just as they may have benefited from lower ones. A prevalent narrative in 2018 related to the effect on emerging markets of tighter financial conditions. The borrowing that led to this narrative may be exquisitely illustrative of the reason restoring market based rates is critical. Along with the normalization of rates, we would welcome the restoration of risk analysis as we all "search for yield."

October 15, 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.