GIA PARTNERS

2nd Quarter 2019

Highlights

- Markets experienced volatility as the trade deal with China collapsed. Ultimately, markets performed well as weaker global economic data led the Fed to presage a rate cut.
- Economic data was generally softer in manufacturing, but services held up well. While growth fears gained traction, the labor market remained resilient and wage indicators improved.
- We are concerned with the incongruity between equity prices and declining yields. The Fed may be cementing a moral hazard that could challenge the restoration of independent financial markets.

Markets

		Returns (%)			
GIA*	Average Quality	2Q19 Gross	2Q19 Net	12 Months Gross	12 Months Net
Core Plus Composite	**(A)**	**3.37**	**3.28**	**8.17**	**7.79**
Global Credit Plus Composite	**(BBB+)**	**3.73**	**3.60**	**8.87**	**8.31**
Emerging Market Debt Composite	**(BB+)**	**4.25**	**4.10**	**11.77**	**11.11**
High Yield Composite	**(B+)**	**3.25**	**3.11**	**NA**	**NA**
Benchmark Bonds					
Bloomberg Barclay's U.S. Agg. Index	(AA+)	3.08		7.87	
Treasury	(AAA)	3.01		7.24	
Credit	(A)	4.27		10.34	
Mortgage	(AAA)	1.96		6.22	
Government/Credit	(AA)	3.53		8.52	
ICE BofAML U.S. Corporate & Yankees	(A-)	4.19		10.28	
ICE BofAML U.S. Corporate	(A-)	4.35		10.56	
ICE BofAML U.S. High Yield	(B+)	2.57		7.58	
ICE BofAML EM Corporate Plus	(BBB)	3.24		10.22	
ICE BofAML Global Gov't ex-US	(AA-)	2.06		4.78	
JPM Emerging Markets EMBI+	(BB+)	4.36		11.68	
JPM CEMBI Broad	(BBB-)	3.51		10.69	
JPM GBI-EM Global Diversified	(BBB)	5.64		8.99	
Benchmark Equities					
S&P 500	NA	3.79		8.22	
Nasdaq Composite	NA	3.58		6.60	
Russell 2000	NA	1.74		-4.66	
MSCI EAFE	NA	2.50		-1.86	
Europe	NA	2.90		-1.17	
Japan	NA	0.84		-6.13	
MSCI Emerging Markets Equity	NA	-0.31		-1.37	

Markets

Non-market participants would be forgiven for questioning the schizophrenic turn in sentiment amongst investors during the second quarter. The S&P 500 closed at a record high on April 30, followed by a 6.6% decline in May and a new record close on June 20, 2019. Meanwhile, the 10-year U.S. treasury closed at 2.50% on April 30, 2.13% on May 31, and 2.01% on June 30. In early May, trade negotiations between the U.S. and China broke down, leading investors to expect a protracted trade war and further deterioration in the global economy. This prospect induced many central banks to countenance rate cuts and other stimulus policies. Ironically, equity markets took this potential support optimistically and moved higher, while bond markets took the opposite view moving yields lower, including record negative rates for German Bunds. Away from government bonds, higher risk sectors held up in June, with high yield delivering particularly impressive year-to-date results. Commodities were mostly lower, although some products experienced higher prices related to supply disruptions (corn and hogs). The Bloomberg Dollar Index, which saw a high print for 2019 on May 29, ended modestly down for the quarter and year-to-date.

Investment grade credit spreads tightened, and the corporate debt market rode a decline in long-term interest rates to deliver strong absolute and relative returns. Investors brushed aside the potential economic implications of the trade war to focus on the Fed's likely assistance. The investment grade corporate bond index, the ICE BofAML U.S. Corporate Index (C0A0), was up 4.34%, including a 2.30% surge in June. By comparison, the U.S. treasury index rose 3.06% as long term rates moved lower on expectations the Fed would cut rates at its July meeting. By quarter-end the two-year treasury yielded 1.76% with Fed Funds at 2.3%. Corporate option adjusted spreads (OAS) narrowed by 4 b.p. to 121 b.p., while the yield to worst of the index declined from 3.66% to 3.20%. Issuance for the quarter was $290.5 billion approximately 25% lower than the first quarter and comparable to last year's second quarter total. Improved sentiment and lower rates encouraged companies to tap the market. Year-to-date the index returned 9.57%.

The high yield market continued its torrid 2019 performance largely ignoring cautionary messages from the partly inverted yield curve. The sector benefited from a renewed search for yield as higher quality bond yields plummeted. The ICE BofAML U.S High Yield Index (H0A0) returned 2.56%, following a strong first quarter and extended year-to-date gains to 10.16%. Spreads to worst widened by 12 b.p. from 407 b.p. to 419 b.p., while the yield to worst decreased from 6.39% to 6.04%. High yield retail investors withdrew $0.6 billion during the quarter, as healthy inflows in April and June were more than offset by outflows in May. The default rate increased to 1.46% (1.55% including distressed exchanges) in June from 0.94% in March, but remained well below the long term average of 3.46%. The new issue market showed no signs of weakening with $74.7 billion in issuance compared with $65.4 billion in 1Q. Leveraged debt investors tilted their preference toward fixed rate instruments following the Fed's dovish turn.

Emerging markets bonds also benefitted from the global decline in interest rates and the weakening of the U.S. dollar. Fragility in the policy accomplishments of some economies, like Turkey, Mexico and Brazil was set aside as the benefits of lower rates took precedence. For the quarter, the JPM Emerging Markets Bond Index Plus (EMBI+), a dollar denominated sovereign index, was up 4.36%, the JPM Corporate Emerging Markets Broad Index (CEMBI Broad) returned 3.51%, and the JPM Global Bond Index – Emerging Markets Global Diversified (GBI-EM Global Diversified), a local markets index gained 5.64%. Year-to-date these indexes returned 10.78%, 8.86%, and 8.72% respectively.

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 20 b.p. for the quarter, but was behind by 8 b.p. over the last twelve months. Credit markets performed well during the quarter, although one of the best performing sectors was investment grade credit, which enjoyed the dual benefit of narrowing spreads and declining rates. High yield and emerging markets performed well, but high yield

underperformed the Aggregate Index. Quarterly outperformance came primarily from exposure to emerging markets and an underweight to mortgages, which underperformed as lower interest rates accelerated prepayments. While portfolios were nearly index-weight in investment grade credit security selection contributed to excess return. Exposure to high yield and an underweight to government bonds detracted slightly from performance. Over the past 12 months, the modest underperformance was due to the portfolio's exposure to below investment grade securities, which did not enjoy as large a boost from spread compression and declining rates as higher grade sectors.

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 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 35 b.p. during the quarter and was behind by 159 b.p. over the last twelve months. The portfolios had an allocation that favored investment grade over high yield and about 10% of the overall exposure was to emerging markets securities. During the quarter, the best performing sector was U.S. investment grade credit, which the portfolios were underweight favoring emerging markets names. That underweight caused the modest underperformance. Over the past 12 months, the portfolios' underweight to investment grade credit and modestly short of index duration caused 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 Composite outperformed the benchmark by 86 b.p., net of fees and was ahead by 89 b.p. over the last twelve months. During the quarter emerging markets delivered strong performance, although some countries faced challenges. The portfolios were overweight Latin America with emphasis in Brazil, where progress on critical reform legislation received investor approval. The portfolios were underweight in Asia, which enjoyed the benefit of lower rates, but did not benefit from spread compression. Over the last twelve months, the portfolios benefitted from adding exposure to countries like Argentina, weakened last year by a current account crisis.

Our *High Yield Composite* consists of portfolios investing primarily in bonds issued by U.S. borrowers with below investment grade credit ratings. The portfolio is measured against the ICE BofAML U.S. High Yield Index (H0A0). The Composite outperformed the benchmark by 54 b.p. net of fees for the quarter. The Composite started in October 2018 and does not yet have twelve months of performance. For the quarter, most of the outperformance came from favorable security selection in industries like energy, commodities, basic and technology. The portfolios are permitted to hold exposures to non-U.S. borrowers, including from emerging markets. Emerging markets outperformed high yield during the quarter and provided a modest positive contribution.

Economy

The second quarter of 2019 threw a whip-saw of economic data, sentiment and market performance at investors and economists. Considering the underwhelming payroll report for March, derailment of a largely complete trade deal with China and, on balance, deteriorating global economic data, financial markets performed surprisingly well. The quarter was one of those ironic periods where bad news became good news because markets expect the Fed to come to the rescue. We, like the economists we follow in the WSJ Monthly Economic Survey, were a bit surprised.

During the quarter, global manufacturing data deteriorated, while services activity held in reasonably well. U.S. inflation remained in check, although wage and rent numbers accelerated in June. Sentiment measures remained elevated and

consumption indicators suggest retail spending continues at a decent clip. Early in the quarter, economists brought down their growth forecasts for 2Q and the remainder of the year, despite first quarter growth exceeding their expectations.

This quarter's review of industries revealed less pessimism and retrenchment among companies than the broader macro data suggests. One widely followed industry, autos, experienced lower volumes, especially in China where sales are down 10% through June. However, the industry is investing heavily in electric vehicles and autonomous driving, which is keeping suppliers and ancillary businesses busy. While China's slower growth rate affected many industries, including commodity producers, some commodities benefited from supply disruptions, leaving some segments with reasonable profitability. In services, media companies continue to pursue content while competition among streaming platforms heats up. In aggregate, corporate cash flow remains robust, consumer focused industries continue to spend and managements are cautious, but not retrenching.

We concluded the U.S. economy has shifted to a slower pace of growth, but is not at imminent risk of recession. Europe's growth rate has disappointed due to the pause in manufacturing, but we expect recovery in the second half of the year. China continues to be challenged, but we believe the government has ammunition to keep the growth rate at a palatable 6.0% to 6.3%.

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 2.0% in 3Q and 4Q 2019. While the U.S. economy has shifted to a slower pace of growth, we believe the realized rate of growth will exceed expectations. With employment elevated and wages improving, consumption should power much of the improvement. The Fed's decisively dovish turn will likely keep interest rates low, aiding housing activity and durable goods purchases. While external factors are driving concerns for the global economy, we believe incentives are in place to halt economic deterioration in Europe and China. The trade dispute remains a risk for the U.S. and China, although both countries are highly incented to reach an amicable solution. We remain optimistic there will be a deal by the fourth quarter of 2019. PROBABILITY 60%

2. A second scenario has the economy returning to an above-trend growth rate of 3.0% over the next six months. If the U.S. and China announce a comprehensive trade agreement that restores the free flow of goods and services, the confidence effect could be meaningful for both economies. In addition, with monetary authorities resorting to stimulus, recent economic sluggishness may prove temporary. PROBABILITY 20%

3. A third scenario has the economy declining to a 1.0% growth rate. Financial markets delivered extraordinary performance during the first six months of the year, driven largely by expectations for a monetary easing cycle. Easing will likely commence in July, but it may not suffice to arrest economic deterioration, especially if a trade deal fails. With companies placing some investment plans on hold and foreign economies faltering, a trade war could depress sentiment and economic activity. PROBABILITY 20%

Market Outlook

Global economic data tilted to the downside during the second quarter, although U.S. employment and wages remained strong. Many observers blamed the trade friction for the weakness and concluded monetary authority support was warranted. We believe economic conditions in the U.S. do not yet warrant rate cuts. Additionally, we are concerned with the incongruity between the lofty performance of equity markets and the generalized call for lower rates. We believe the U.S. Fed can continue to be patient, which may push interest rates across the curve higher. Their accommodative bias, however, will be helpful to higher risk credit sectors by keeping borrowing costs low and refinancing options available.

Commentary – Equities Higher, Yields Lower, Unusual Times

Through June 30, 2019, the NASDAQ Composite was up 20.7% and the S&P 500 was up 17.3% for the year. The S&P 500 index hit a record high on June 20, and other U.S. equity indexes were near records during the final days of June. On November 8, 2018 the ten-year U.S. treasury yielded 3.24% and on June 30, 2019 the ten-year yielded 2.01%. Historically, strong equity markets have not been accompanied by declining yields, but 2019 is proving to be most unusual.

Equity markets have tended to be arbiters of economic activity. Strong markets generally preface robust or improving activity, and a good economy tends to be accompanied by higher, not lower, interest rates. Commencing in the fourth quarter of 2018, economists began to downgrade their growth expectations for both the U.S. and global economies. Supporting their bearish shift, economic data, especially in manufacturing, began to deteriorate. Observers attributed the underperformance to the trade disputes the Trump Administration initiated with China, Europe and Mexico. However, despite the friction, U.S. unemployment data hit fifty year lows, job openings exceed job seekers by nearly one million, services continued to be strong globally and GDP growth surpassed 3.0% on an annual basis during the first quarter of 2019. Despite this and record high equity indexes, the Fed is expected to cut rates at the end of July. Perhaps the Fed feels duty bound to react to economic weakness abroad or maybe they are taking anticipatory measures because of the trade friction. Either way, doubters may be pardoned for questioning the wisdom of rate cuts on the heels of record equity prices.

The U.S. has not faced a period like this in some time, and we think the incongruity between equity prices and zero to negative real rates should be a source of concern. The table below shows historical levels of equity markets (represented by the S&P 500) and yields of the ten-year treasury six months before and six months after the Fed changed the direction of monetary policy. It is unusual to see equity markets rising ahead of Fed easing, whereas it is common to see yields falling. If one adheres to the notion that markets provide information, bond yields and Fed action would suggest the economy is faltering, which begs the question, what message are equity markets delivering?

Markets Behavior and Fed Policy

		S&P 500			UST 10yr Yield (%)		
Date	Fed Action	6 mo. Prior	Action Date	6 mo. Later	6 mo. Prior	Action Date	6 mo. Later
9/9/1998	Easing	1095.44	1049.02	1310.17	5.66	4.92	5.26
6/30/1999	Tightening	1231.93	1372.71	1464.47	4.65	5.78	6.37
1/3/2001	Easing	1469.54	1347.56	1234.45	5.99	5.16	5.38
11/6/2002	Add'l Easing	1052.67	923.76	929.62	5.07	4.04	3.79
6/30/2004	Tightening	1109.64	1140.84	1213.55	4.26	4.58	4.26
9/18/2007	Easing	1402.06	1519.78	1330.74	4.57	4.47	3.48
12/16/2015	Tightening	1937.78	1972.74	2100.44	2.31	2.30	1.58
7/31/2019	Easing ?	2704.10	2992.02	?	2.63	2.05	?

Clearly, equity markets are applauding the Fed's support, and, away from U.S. treasury yields, narrowing credit spreads suggest the central bank's action will postpone a deterioration in creditworthiness. The global search for yield is alive and well with the full blessing of monetary authorities. But should markets be so enthusiastic? After the 2008-2009 recession,

monetary authorities pursued extraordinary measures to support their economies. Housed in terms of "necessity," measures like negative interest rates, limitless purchases of government bonds and the abolition of a "real" rate of interest, became acceptable experiments as long as inflation remained at bay.

It seems the flaw in central bank thinking may now be reappearing. Like a patient addicted to pain killers, monetary authorities were not able to restore markets to their proper independent and unsubsidized functioning before being called back to action. It appears the Fed, the ECB, the BOJ and the Bank of England are now saddled with moral hazard, leading economic actors to rely on their support at the first signs of stress. The behavior of markets has been perversely altered by the authorities to encourage relentless borrowing by governments and corporations. To exit the vicious cycle, the global economy needs real growth, something government borrowing does not accomplish.

For now, we expect the Fed to cut rates on July 31 and higher risk markets to endorse the move. Longer term, we continue to worry that zero real rates (and negative rates in Europe and Japan) will promote improper incentives and risk-taking in the market. When those risks become excessive, the Fed (and others) may not have the tools to combat the fallout.

July 15, 2019

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. High Yield Index
The ICE BofAML U.S. 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.