GALLIARD
Capital Management, LLC
ARCHITECTS OF INVESTMENT SOLUTIONS

4th Quarter 2022

One year ago, we commented in our client letter "…the Galliard team is excited for the opportunities that change will bring. 2022 is poised to bring great things, but as we have seen time and time again over the years, there will likely be some volatility that accompanies those great things, especially in the financial markets." Looking back over the past 12 months, we were a little understated in our anticipation of "some volatility." Now being able to look in the rearview mirror, the best theme for 2022 should be perseverance.

As a member of our investment team put it, "Pretty much everything that happened in 2022 in regards to inflation, monetary policy, real rates, yield curve re-shaping and fixed income returns has been the worst/most dramatic that we've seen in the last 40 years." You can see more of this in the enclosed economic commentary with your client reports, but here are a few highlights:

- Virtually all measures of inflation are the highest since 1981-1982.
- The Fed has had an equally historic response. In nine months, since March, they have raised the policy rate 425 bps. However you want to slice it (6-month period, 9-month period, 12-months YTD, etc.), this is the fastest, most aggressive policy tightening since 1981.
- The Treasury yield curve reacted in step with the Fed moves; for example, 2-year Treasury rates ended the year 370 bps higher than year-end 2021. Again, on a calendar year-to-date basis or on a rolling 12-month basis, this has been the largest rate move since the early 1980s. There are other points along the curve with equally historic stories.
- The same can be said for the yield curve re-shaping. At one point in early December, 10-year vs 2-year yields were inverted by 84 bps. That was the steepest inversion since 1981. Considering that the curve was positively sloped by 78 bps at the end of 2021 and ended the year at -55 bps, the relationship between 2s and 10s yields changed by 133 bps on the year. This puts the curve re-shaping of 2022 in the company of 1981, 1989, 1994 and 2005.
- The dramatic changes extend to real interest rates as well. Reflecting tighter financial conditions and the effects of Quantitative Tightening (Fed balance sheet reduction), 10-year real yields ended the year a whopping 268 bps higher than at the end of 2021. This is remarkable, and far and away the largest real rate move in series history.

As a result, fixed income total returns were dismal in historic proportions. Looking back to the inception of the Bloomberg U.S. Aggregate and Intermediate Aggregate Indices, 2022 posted a -13.01% for the Aggregate and -9.50% for the Intermediate Aggregate – the worst annual total returns we can find in their data back to 1976.

In short, the past year was the most challenging year for Galliard's investment style, which since inception has emphasized broad diversification across the spread sectors and higher credit quality. Yet our team persevered, and our portfolios weathered the storm. We didn't come through unscathed, nor should we in such a landmark year of virtually every indicator of volatility, but the portfolios in general held up well to their benchmark's performance. It's a result we're proud of and shows that our team was hard at work during an amazingly complex year.

The gyrations in the U.S. fixed income markets almost make us forget the other monumental changes we were living through last year – shifting back into a (new) normal return to work post COVID lockdown in 2nd quarter; the Russian invasion of Ukraine and all the related economic tremors; supply chain challenges thanks to two years of COVID lockdowns; and significant weather events that affected many of us over the course of the year. Through it all, our team remained focused in working to bring you solid portfolio performance coupled with the client service you have come to expect from us. So, "perseverance" is the theme looking back on 2022, and it also holds true as we look into 2023.

2023 is poised to bring more volatility to the markets. The word recession seems to be common in investment discussions, yet when and how long are hard to answer. You may remember we also began using the term "sticky" more last quarter. That could be the silver lining – it looks like the higher rate environment is here to stay for the near future. Yield to maturity in portfolios has trended up over this past year as we've been able to invest at higher rates, and that trend should continue. For our stable value clients whose returns have been protected from the past year's volatility, that's apparent in the gradual increase in crediting rates to your participants that we've experienced in the past year and expect to continue at least over the near-term. With that in mind, interest rates are looking to remain elevated, and there are indications the Fed may continue to increase policy rates further. Regardless of what the year may bring, we will continue work to persevere and stay focused on the task at hand – providing the consistency that has served your portfolios well since 1995.

Here's to perseverance.

Ajay Mirza and Mike Norman

Senior Managing Principals