Fixed Income

Quarterly
Commentary
As of December, 31 2019

Market Commentary

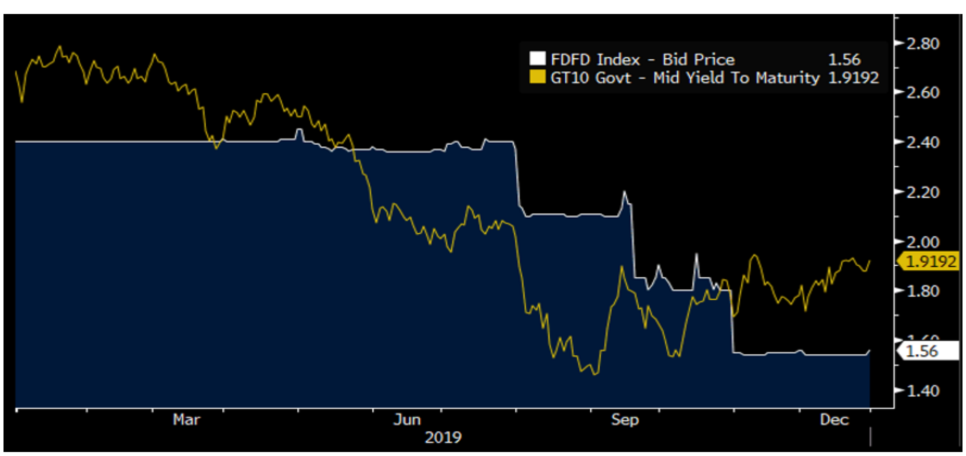
In the fourth quarter of 2019 volatility was less pronounced than prior quarters. With this reduced volatility, returns in the U.S. equity and credit markets were positive, while interest rates for U.S. Treasuries were generally higher. Risk markets, mainly stocks and credit markets, rose throughout the quarter as risk-on trades took center stage and yield curves steepened. During the quarter, the S&P 500 was up 9.06%, the MSCI ACWI was up 9.05%, the Bloomberg Barclays High Yield Index was up 2.61%, and the U.S. Treasury 10yr yields rose from 1.67% to 1.92%. Investors took comfort in progress made in trade negotiations with China, Mexico and Canada, more certainty of a Brexit deal, and the Federal Reserve delivered a quarter-point ease in the Fed Funds Rate while promoting its stance that the economy is sound, inflation is still below target, and it has arrived at a neutral policy stance that is expected to be in place for the foreseeable future. Fed Funds futures now project the next change in Fed Funds rate could be late 2020 or later.

10yr Treasury Yields, S&P 500, and VIX – Changes during 4Q19

Source: Bloomberg, LP

The graph above shows relevant charts of U.S. 10-year Treasury yields, S&P 500 equity values, and the VIX Index. Two primary observations jump out. First the quarter started with high level of market volatility, with the S&P and bond yields declining and VIX spiking higher. Second this graph also shows a return to traditional expected correlations among markets, with interest rates and stock prices rising along with volatility declining. It may be too early to predict a return to "normal" markets, but observing commonly expected hedging outcomes is an encouraging sign. We expect that markets will continue to be impacted by several factors, including global central bank intervention, steepening yield curves, negative yielding global bonds, along with non-economic factors like the U.S. impeachment inquiry, protests in Hong Kong, and electoral politics.

The Fed is Back (on Hold)?



Source: Bloomberg, LP

Portfolio Management

Guy Benstead
Portfolio Manager

Guy Benstead has over 30 years of fixed income experience in the credit and interest rate risk markets. Prior to joining Shelton Capital, Guy was a Partner of Cedar Ridge Partners, LLC. He was a member of the Portfolio Management Team, the firm's Investment Committee and the Risk Committee.

William Mock
Portfolio Manager

William Mock has over 19 years of experience as a trader and portfolio manager of fixed income and derivatives portfolios. William has been a portfolio manager at Shelton Capital since 2010. William earned a B.S. in Electrical Engineering, Kansas State University; MBA, University of Chicago Booth School of Business.

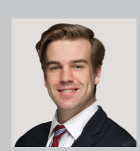
David Falk
Portfolio Manager

David Falk has over 30 years of broad-based fixed income experience as a trader, research analyst and investment banker for firms including Cedar Ridge Partners, LLC, Bear, Stearns & Co. Inc. and Lazard Freres with a focus on the municipal securities market. He is a Portfolio Manager for Cedar Ridge Investors Fund I, LP, Shelton Tactical Credit Fund and the Green California Tax-Free Income Fund. He holds an M.R.P from the University of North Carolina at Chapel Hill and a B.A. from Northwestern University

Jeffrey Rosenkranz
Portfolio Manager

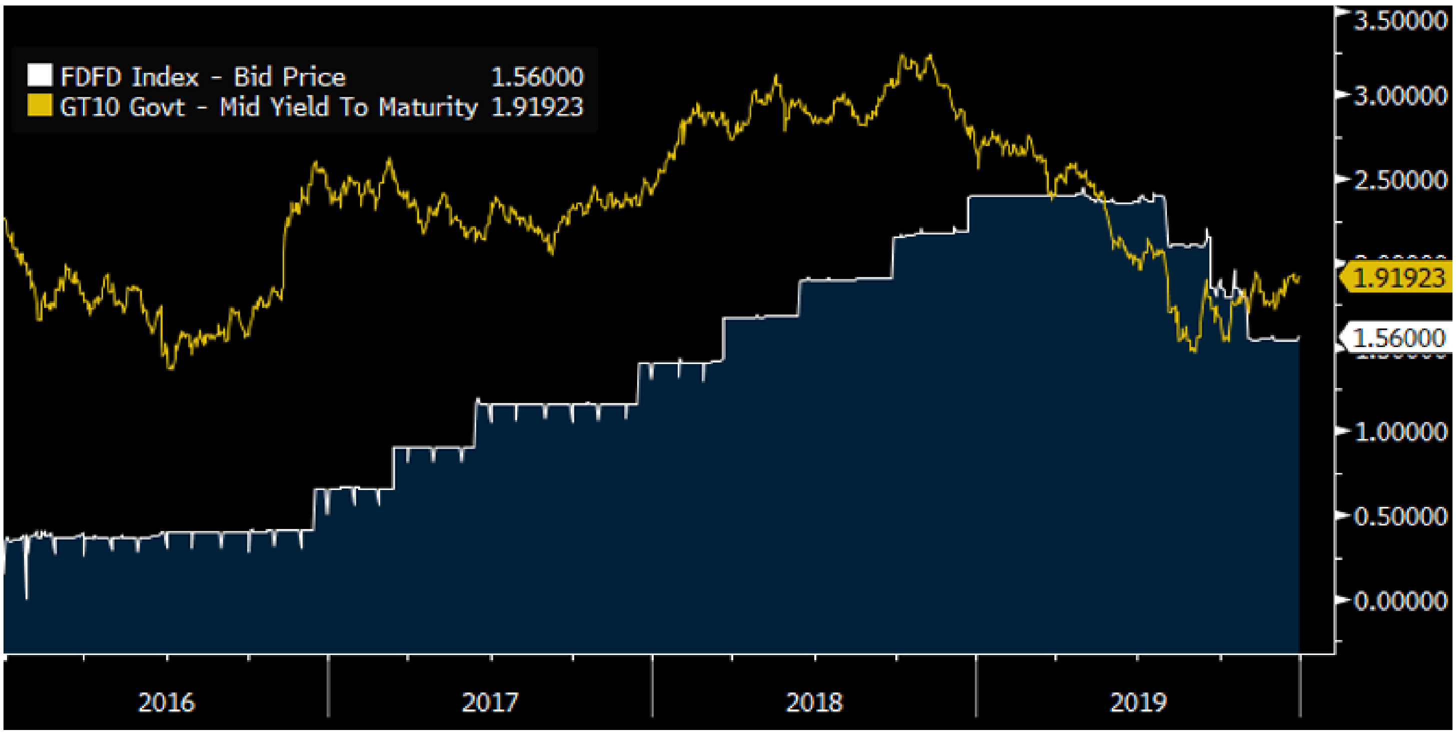
Jeffrey Rosenkranz has over 22 years of experience investing in the credit markets, with an emphasis in high yield, distressed debt, and special situations. Prior to joining Shelton Capital, he served as a Portfolio Manager for the Cedar Ridge Investors Fund, I, LP and the Cedar Ridge Unconstrained Credit Fund, as well as serving as a member of the Portoflio Management Team, the Firm's Investment Committee and the Risk Committee.

Chris Walsh
Portfolio Analyst



Chris Walsh has over five years of experience analyzing credit and equity markets. Chris earned a B.A. in Economics, Villanova University.

As mentioned, The Federal Reserve lowered rates at its October meeting, which followed similar moves twice during the third quarter, confirming that the Fed's policy bias has shifted from tightening to easing. The Fed's target rate for federal funds now stands at 1.50% - 1.75%, and Fed Funds futures markets are predicting no further cuts until possibly late 2020. The graph above shows the three Fed Funds target cuts this year, and demonstrates how the bond market has responded to the Fed policy shifts this year. Note 10-year yields declined in advance of the Fed easing. Now that the Fed has signaled pause, yields have stalled and have actually begun heading higher. The upward pressure on rates is a result of both technical and fundamental factors. Technically, with the Fed Funds rate projected on hold, absent near-term recession fears, there is little reason for long-term rates to decline further, which would severely invert the yield curve. Fundamentally, a continued stock market rally, easing trade tensions, continued strong employment and consumer spending data, and bottoming out of business capital spending all point to stable economic conditions at worst, and the possibility of above trend growth in 2020. Recent projections of an impending global recession seem to be fading into the background.



Source: Bloomberg, LP

The above graph shows Fed Funds and 10-year treasury rates since the Fed began to raise rates back in 2016. Note that even when the Fed Funds target was close to 0%, the lowest 10-year yields traded was around 1.5%, and the yield curve was positively sloped by 150-200 basis points (bps). This yield spread currently stands at around 35 bps, significantly steeper than the inverted 65 basis point trough reached earlier this year, but still well below what one might call "normal". If the Fed Funds remains flat for the next year, and the economy continues to stabilize or improve, a return to normal yield environment could result in higher long-term rates and a steeper yield curve. While the bond markets delivered stellar returns in 2019, a lot of these returns could be at risk in a higher rate, steeper curve scenario.

The Fed has signaled that it will continue its stance that it will adjust policy when and if data shows that the economy is either growing or slowing ahead of expectations. We also know that Chairman Powell is presiding over a Federal Reserve that has policy sensitivity to market inputs. In other words, a "Powell Put" is in place to support the markets, not just in response to economic fundamentals. The Fed has stated it will not follow any "pre-determined" path for rates; instead it's policy directives will be subject to economic data and financial market developments. Based on commentary from Chairman Powell the Fed will also adopt a "symmetric" view towards inflation targeting. (Note the European Central Bank (ECB), under new President Christine Lagarde, has said it will take a similar "symmetric" approach to inflation policy.) More simply, if the Fed's inflation target is 2%, it will create policy directives that allow for inflation to be "on average 2%" over some un-determined period of time. Since inflation has been predominantly below 2% for the last 10+ years, can we assume that the Fed will keep policy unchanged even if inflations accelerates to above 2% for the next 10+ years? How much tolerance will the bond market have for a Fed that stands complacent in the face of rising, or accelerating inflation dynamics?

At the end of the third quarter, we stated that we have been running rate hedges and overall gross exposure lower than normal levels for most of the year and that as rates and risk markets have diverged, we anticipated that either rates will move higher or risk premiums will improve, which will provide an opportune re-entry point. We believe we have reached this re-entry point as rates have begun to move higher and selective risk markets have become attractively priced.

Credit & Municipal Market Comments

During the quarter corporate credit outperformed municipals, while municipal bond performance vs rates was mixed. The U.S. Aggregate Index and U.S. Credit Index posted returns in the fourth quarter of positive 0.18% and 1.18%, respectively. The U.S. High Yield Index posted a positive 2.61% return in the quarter. Notably, bucking a trend that has been in place all year, higher yielding Triple-C credits outperformed all higher rated corporate bond categories.

In the municipal market, technical factors became mostly supportive in the fourth quarter; Muni demand remained strong as inflows into tax-exempt mutual funds continued for a 52nd consecutive week, totaling $25.2 billion per Lipper. At the same time, new issue supply ramped up to $179.6 billion for the quarter, an increase of 59.8% compared to the fourth quarter of 2018. Despite rising level of market interest rates, the Municipal Bond Index posted a positive 0.74% return, and the High Yield Municipal Index posted a positive 0.90% return during the quarter.

Most long-term U.S. Treasury yields rose during the fourth quarter; with 10-year levels up 25 bps and 30-year rates up 27 bps from their lows. Importantly, U.S. Treasury yields rose more on the long end of the curve, which resulted in the yield curve steepening. During the quarter Municipal rates were mixed as rates fell in 2-year and 5-years by 18 and 14 bps, respectively, while rates in 10-years and 30-years rose by 2 and 8 bps, respectively. Where the 30-year "AAA" Municipal/UST ratio ended 2018 at 100.3%, the ratio ended the quarter at 89%. In 10-years, the ratio stood at 76% versus 85.1% at year-end 2018. An interesting observation still concerns the flatness of the U.S. Treasury and relative steepness in the Municipal yield curves. At December 31, 2019, the 2-10 year U.S. Treasury yield curve was positively sloped by 35 bps, steepening by 24 bps in the quarter, while the 2-10 year MMD yield curve steepened by 20 bps to +40 bps. As the same time the 5-30 year U.S. Treasury yield curve was 70 bps, 7.5 bps steeper on the quarter, while the 5-30 year MMD yield curve was 100 bps, 22 bps steeper on the quarter.

Credit spreads across Investment Grade and most High Yield corporates and High Yield municipals continue to be at or near cycle tights. We continue to focus on out-of-favor or undervalued B and CCC credits with a clear process and catalyst to drive total returns, and have begun to add risk in these sectors based on what we see at a strong relative value opportunity, while we continue to be underweight BBB and BB credits where we see downside from cyclical or structural changes that present asymmetric risks.

High Yield Corporate Commentary

Trading in October was turbulent and defined by speculation around U.S.-China trade talks, with high yield corporates ultimately ending slightly positive on the month. As prospects for a phase one trade deal between the U.S. and China appeared to improve, November was the heaviest month of high yield issuance since September 2017. The bifurcation in high yield continued however, with Double B and Single B bonds providing moderately positive returns while CCC bond returns were negative. Notably, the High Yield Energy Sector marked its 5th straight month of declines. In the second half of December, high yield corporates rallied across the board, with CCCs making up some of their risk-adjusted underperformance for the year as investors looked ahead to 2020 and digested moderating geopolitical risks and some encouraging macro data.

We believe the dispersion in quality stems from fears including the age of the credit cycle, election uncertainty, and stretched historical valuations. While we acknowledge these factors, we believe these market concerns help create a credit pickers market, and that "diamonds in the rough" can be found if one is willing to do the name-by-name credit work.

U.S. High Yield Bond and Loan default rates are up to 2.9% and 2.2% from 1.8% and 1.5% respectively at year end 2018, according to JP Morgan. As the headwind from global trade diminishes, we see little reason to expect much of a pickup in these rates for the near future. The heavy pace of refinancing in recent years has left balance sheets in a solid position and a supportive Fed/economic backdrop should allow capital markets to remain open.

Municipal Market Commentary

The municipal bond market performed well during the fourth quarter and throughout 2019, supported by the fundamental drop in benchmark U.S. Treasury yields through the year and continued impact from changes to the tax code altering the supply of municipal bonds. Under the 2017 federal tax legislation municipal bond issuers were limited in their ability to refinance their debt on a tax-exempt basis. Taxable bonds remained an option to advance refund tax-exempt bonds for debt service savings, but such issues were relatively limited --- that is, until the summer of 2019 when interest rates fell, and the economics of taxable refunding transactions began to work for issuers. Over just a few months taxable issuance took off and through October 2019 was up 89% compared to the same period in 2018. While we are seeing this growth in taxable municipal issuance, we also have experienced 52 weeks of consecutive inflows into tax-exempt municipal bonds funds. This combination of (1) taxable bonds replacing a significant amount of what might otherwise be tax-exempt bonds in the new issue market and (2) robust investor demand, has been a constructive factor for tax-exempt municipal bond performance. Even as the U.S. Treasury yield curve rates have fallen across the curve in 2019, municipal bonds have rallied even more with the ratio of AAA municipal bond yields to U.S. Treasury yields falling over both the calendar year and 4th quarter across the curve.

In the municipal market we are maintaining a diversified portfolio in multiple sectors including transportation, health care and project finance. Our focus remains on revenue bonds and we continue to avoid sectors with perceived political risk or execution risk. We continue to follow net supply and fund flows closely for clues to market technicals, and opportunities to add on weakness.

Economic Observations

On the economic front, mixed signals abound. U.S./China trade tensions dominated the quarterly economic dialogue. We expect the politics of trade disputes to continue throughout the rest of the coming year and ongoing uncertainty around the prospects of a phase-2 China trade deal being struck before the 2020 Presidential election next November. Despite the challenges of predicting the outcome and impact of ongoing trade tensions, U.S. payrolls have continued to show jobs growth, albeit at a more uncertain pace. Job creation rose strongly in the fourth quarter; non-farm payrolls rose an average of 205,000 per month, which was a strong improvement vs the third quarter average of 160,000, highlighted by a 266,000 initial read for November. The upcoming payroll numbers for December are projected to show a gain of 168,000. The Unemployment Rate dropped to a cyclical low 3.5% in the fourth quarter and is expected to remain at 3.5% into the first quarter 2020.

Average hourly earnings have steadily improved, averaging 0.3% per month in 2019, and are expected to continue to grow at a steady pace in 2020. The labor force participation rate has also remained steady at 63.2%. Third quarter GDP came in at 2.1%, significantly lower than second quarter 4.6%, but mostly ahead of early projections. Many concerns about a slowdown over the coming quarters, based mainly on trade uncertainty, no-deal Brexit risks, and general global unrest in Hong Kong have begun to subside, and a certain degree of optimism may be returning. While volatility declined throughout the equities and fixed income markets during the fourth quarter, we would expect the first quarter 2020 volatility will again be elevated.

Recent Events and Market Outlook

The recent attack by the U.S. on the Iranian military leader in Iraq has caused near term volatility, however we do not think this event will create a long-lasting market impact. We are more focused on the following near- and long-term sources of market risk:

- The near-term impact of upcoming releases of 4Q19 corporate earnings and outlooks for 2020. With much of the credit markets priced to perfection, we expect to see idiosyncratic volatility in specific sectors and credits.
- The near-term impact on the North American industrial manufacturing supply chain of Boeing's shutdown of 737 Max production and a slowdown in the auto production pipeline.
- The long-term effect of ongoing Central Bank stimulus and focus on creating global inflation. This could lead to higher rates and a steeper yield curve potentially posing a meaningful risk to the bond markets.
- The long-term implications of pending trade deals with China and USMCA.

We saw very strong returns across the fixed income markets during 2019, but do not expect these results to repeat in 2020. The results from the past year were primarily driven by beta and duration, while relative value investing lagged. In a reversal of 2019, we believe 2020 results will be driven by idiosyncratic relative value changes as opposed to returns based on general market risks