SHELTON CAPITAL MANAGEMENT

Shelton International Select Equity

QUARTERLY
Commentary
As of March 31, 2021

Executive Summary

- International equity markets, as defined by the MSCI ACWI ex U.S. Index, continued to rise on the hopes of both continued economic recovery and continued stimulus.
- The Shelton International strategy slightly underperformed its benchmark in the first quarter of 2021.
- Canada was the biggest winner in Q1 followed by the U.S.
- Emerging markets were the worst performing, led by China.

Portfolio Manager

Andrew Manton

Andrew Manton is the Portfolio Manager for the Shelton International Strategies. Mr. Manton has over 20 years of investing experience at WHV, Victory Capital Management, Deutsche Asset Management and Merrill Lynch. He earned an MBA from the Tepper School of Business at Carnegie Mellon University and a B.S. from the University of Illinois at Chicago.

Portfolio Performance

In the first quarter of 2021, the Shelton International Select Equity strategy (2.72%) slightly underperformed the benchmark MSCI ACWI ex U.S. index (3.5%) by 78bps. The quarter again started off well for growth stocks but at mid-quarter, growth sold off as the threat of inflation and, thus, higher interest rates clouded the outlook of growth stocks with ultra-high valuations. Value stocks, however, maintained their mid-quarter level and achieved the second consecutive quarterly outperformance in many years.

Market Review

The first quarter of 2021 marked the one-year anniversary of the coronavirus pandemic that was first discovered in Wuhan, China. While vaccination efforts in the U.S. kicked into high gear and most states began to allow businesses to open fully, most of the rest of the world continued to struggle with stalled vaccination efforts, new variants, and the continued need for partial shutdowns.

Europe

Countries in Europe kept battling the spread of the virus around the continent in the first quarter. German Chancellor Angela Merkel told her party colleagues that the pandemic had slipped out of control in January. A fear of the spreading variants and the uneven vaccine distribution across the E.U. led her to close the German borders and delay the reopening of stores. France tried to avoid another nationwide shutdown and instead tightened restrictions in certain parts of the country. However, by the end of the quarter, the government admitted they were in the grips of a third wave and the entire country was placed in a month-long lockdown. Both German and French cases rose sharply in March.

Italy provided the annual drama of a government collapse followed by the appointment of a new coalition government, this time led by former European Central Bank (E.C.B.) president, Mario Draghi. The new Prime Minister proclaimed his opposition to fiscal austerity despite soaring debt levels in Italy. In March, his government introduced a €32bln package that included new subsidies to the labor market, bringing the total stimulus Italy has allocated due to the epidemic to over €130bln. The country is now expected to reach a new record debt-to-GDP level by the end of this year—close to 160%—and with most of the country still in lockdown and the desire of the new government to extend its tenure, there may be more stimulus announcements to come.

The virus resurgence will delay a rebound in the European economies. Another GDP decline is now expected in the first quarter. Forecasts for the rest of the year, too, dropped at the end of March following news of further lockdowns. Still, Eurozone flash PMI showed surprising signs of resilience with an expansionary 52.5 reading in March, compared to February's contractionary 48.8 figure. German factory activity led the expansion. Although the service industry recorded a higher level in March, it remained in contractionary territory.

The rise of input prices around the world began to stir the debate about the role that extremely loose monetary policies, now coupled with large fiscal stimulus packages, may have on future inflation levels. E.C.B. and E.U. officials varied in their responses to the many questions posed on the topic. The timing of the reversal of some of the blanket support measures currently in place—such as the loosening of rules around corporate liquidity, loan repayment suspensions, tax deferrals, salary subsidies, and the suspension of borrowing limits—is now being debated across the bloc.

The E.C.B., for its part, conveyed great unease about rising interest rates, with President Christine Lagarde feeling the need to reiterate the central bank's ability to increase its already strong quantitative easing measures. The bank signaled that a rise in inflation will be temporary but is also ultra-sensitive to any rise in interest rates in the near term. The rise in Eurozone 10-year yields, from negative 60 basis points at the beginning of 2021 to negative 30 basis points, was enough for some E.C.B. officials to call for an increase in the pace of bond buying in order to lower rates and control the yield curve. That's an obvious indication of just how dovish, and perhaps addicted to ultra-low interest rates, Europe has become.

U.K.

In late March, the U.K. began to slowly ease its way out of one of the strongest lockdowns of the pandemic, as COVID-19 cases steadily declined since January. And as of April 10th, 47% of the U.K. population has received at least one vaccine dose compared with 15% in Germany and 35% in the U.S. Unlike their peers in other countries, U.K. officials prioritized giving first doses to a larger number of people instead of fully vaccinating a smaller number.

Global health thinkers will be sure to debate the virtues of this "one dose is better than none" strategy for months to come. But at least now, some hope is returning to the U.K. economy. March's manufacturing PMI rose to 58.9, signaling the sharpest factory expansion in 10 years.

China

During the first quarter, the Chinese economy began to moderate. Official PMI in January fell from December with both manufacturing and service industries reporting drops. In February, the Caixin manufacturing PMI fell to the lowest level in 11 months. At the same time, the rise in producer costs was the steepest in 40 months, causing firms to raise their selling prices by the highest rate since November 2016.

Various stories throughout the quarter suggested both the central bank and the government are beginning to plan for lower overall GDP growth going forward. A working paper from the People's Bank of China referred to China's potential growth rate through 2025 at between 5-5.7% per year—much lower than the official target of "above 6%." Officials are concerned that the usual stimulus measures will not be as effective going forward, that they will complicate the already high levels of state and local government debt, and will lead to more inflation.

That's why these officials keep turning their attention to rising credit and property bubbles in some cities. As one of the primary sources of investment and wealth storage in China, property sales are always on the radar of the Chinese government. This has also always been a difficult balancing act, as local governments rely on land sales for revenue sources—total government land sales in 2020 equated to $1.3trl, a sum equivalent to the revenues from China's value-added tax and corporate income tax combined. Nevertheless, in January, the central bank unexpectedly sucked out funds from the banking system in January amid warnings that the excess liquidity was creating market bubbles. As part of the crack-down on Alibaba's fintech affiliate, Ant Group, the Chinese banking regulator also tightened rules on online lending. It used propaganda news outlets to warn that it is looking to curb reckless capital expansion in property and that it will take measures to cool several markets.

Such actions also highlight how the Chinese approach to the pandemic differs from that of the U.S. China is setting conservative growth targets with tighter fiscal-deficit allowances and restrained monetary action. Meanwhile, the U.S. unleashed another $1.9trl stimulus plan, which will soon be followed by a multi-year infrastructure package said to also be another $2trl. The divergence has naturally caused greater demand for the yuan over the dollar as investors piled into higher-yielding Chinese bonds, causing the Chinese currency to rise versus the dollar. That trend eased in the second half of the quarter as U.S. interest rates rose, as higher inflation expectations drove the selling of Treasury bonds.

In early March, the government assembled the annual "Two Sessions" and released its new Five-Year Plan (where official GDP growth targets were set at "above 6%"). After receiving international scrutiny on its previous Five-Year Plans and the infamous "Made in China: 2025" plan that promoted technology "transfer," the government was careful with the message this year. There was talk of supporting multilateral trade and expanding foreign investment into the country to appease outsiders. There was also a mention of increasing the national development of industries the government is focusing on, but there was no language that has appeared in previous documents encouraging the theft of foreign intellectual property.

Also at the Two Sessions this year, officials were very bold in discussing their relatively successful virus containment efforts last year, the quick economic recovery, the successful reunification of Hong Kong with just minor international condemnation, and the change in U.S. presidents. Around the same time, China's foreign minister called on the Biden administration to remove the tariffs and the sanctions that the Trump administration imposed, and to stop the "suppression" of Chinese technology. He also called on the U.S. to support Chinese students and stop restrictions on media outlets and cultural activities inside the U.S. China continues to reach beyond its borders to try to create a favorable narrative around COVID-19.

However, U.S. officials in the new Biden administration are taking much of the same stance towards China as the previous administration. The new Commerce Secretary, Gina Raimondo, has said that her department will make full use of the "entity list" regulatory tool that is used to limit the flow of U.S. technology to Chinese companies. She mentioned Huawei and ZTE as companies that deserve to be on that list.

Secretary of State Antony Blinken also took an early tough stance on China during the bilateral talks in Alaska in March. He frankly laid out the issues that were to be discussed, all topics the Chinese government does not think should be discussed, and which it regularly condemns anyone for bringing up.

Shortly after the meeting in Alaska, the U.S., Canada, U.K. and the E.U. all leveled collective sanctions on Chinese officials over their repression of Uyghurs in Xinjiang. The response from the Chinese was to go after each country involved with sanctions or threats. China's government seems to be getting uncomfortable with the narrative careening out of their control, not only regarding this issue, but with the back story about how and where COVID-19 began.

Most worryingly, the ease in which the Chinese government was able to absorb Hong Kong has perhaps emboldened Xi Jinping to speed up plans to unite Taiwan with the mainland. The People's Liberation Army is conducting daily exercises and drills to invade Taiwan's air defense zone. The regularity of these exercises has caused the U.S. Navy, along with European navies, to send ships into the region. China has also been expanding its presence elsewhere in the South China Sea, the Philippines recently reporting 220 Chinese fishing vessels well inside the Philippine exclusive economic zone. These vessels appeared to be crewed by militias, not ordinary fishermen.

Leaders from Japan, Australia, India, and the U.S.—the so-called "Quad"—met to discuss the situation in the South China Sea in early March. In what looks like an opposing bloc, China has recently signed agreements with Iran and Russia. All this represents the biggest conflict of the post-Cold War era, playing out between China, the ascendant power, on one side and the U.S., the established power, and its allies on the other. As we have stated in previous commentaries, China's attempted takeover of Taiwan represents the biggest geopolitical risk in our opinion.

Other Emerging Markets

Outside of China, the emerging-market world was beset this time not just by COVID-19. Whipsawing U.S. interest rates were also a big variable—January 2021, for instance, saw strong inflows into all emerging markets when U.S. bond yields were low, but the flows fell to a trickle by March as the 10-year U.S. yield spiked, according to data from the Institute of International Finance. Perhaps not coincidentally, commodity prices are rising, affecting these economies' balance of payments.

Consider the effect on India. After more than three months of sub-30,000 new cases a day, COVID-19 began not only spiking but sharply accelerating in March. By the first week of April, India crossed the 100,000 daily case threshold, and by the second week hit 184,000 cases. Such speedy transmission is worrisome, including for the economy. India's fiscal year that begins in April was supposed to show double-digit growth, largely off last year's recession, but that may be in peril now.

What will policy makers do? India so far hasn't shown the appetite for a big COVID-specific fiscal response. J.P Morgan last year pegged India's at below 2% of GDP, compared to more than 10% of GDP in developed countries.

And monetary policy is getting complicated by rising commodity prices—such as oil—that have helped push up inflation. Another complication is the ups and downs of U.S. bond yields, which force the Reserve Bank of India to intervene in currency markets to keep the exchange rate stable, or allow local

yields to climb. Though the RBI kept rates on hold at its latest meeting in early April, its inflation-targeting mandate may prevent it from flooding the system with as much liquidity as it did last year.

In Indonesia, this dilemma may be more explicit since exchange-rate stability is an explicit mandate for the central bank. Its rupiah has depreciated against the dollar since February—probably because climbing U.S. rates diverted capital back to dollar assets—whereas the central bank has openly come out in favor of a stronger currency. That said, unlike India, Indonesia in the past quarter was fortunate to have experienced both low inflation and declining new COVID-19 cases.

Like India, Brazil, too, saw a nasty spike in new COVID-19 cases in recent months, likely due to a new variant of the virus. But here, the death toll is climbing so quickly that the country's fragile politics is under strain. President Jair Bolsonaro is facing intense criticism, in response to which he sacked many cabinet members in late March, which in turn drove the chiefs of the army, air force and navy to resign.

If this weren't complicated enough, inflation is on the rise in Brazil as well, fed partly by rising commodity prices. At the same time, mirroring the broader emerging-market universe, capital sharply fled Brazil in March (after rushing in in January and February)—which weakened the currency and worsened policy makers' fear of inflation via more expensive imports. So in mid-March, Brazilians woke up to their central bank hiking benchmark rates by 75 basis points, even as COVID was decimating growth prospects.

By contrast, South Korea and Taiwan are looking rosier, partly because both have gotten COVID-19 under relative control. South Korean industrial production ticked up sequentially in February, more than the market expected, PMIs continued to expand in March, while exports in March climbed to the highest level since October 2018. These come after the fourth quarter's 1.1% quarter-on-quarter GDP growth. And in Taiwan, the government thinks GDP in 2021 will grow 4.6%, up from its previous forecast of 3.8%.

This being the emerging world, stories of autocratic woe also abound. Turkey's President Recep Tayyip Erdogan fired his central bank governor in late March for keeping interest rates too high. Ironically, that only led investors to dump lira assets, including bonds, which in turn pushed up yields. In Myanmar in February, the military once again seized power by overthrowing Nobel Peace Prize winner Aung San Suu Kyi's democratic government.

The U.S.

Stimulus was once again the biggest driver of market sentiment in the U.S. during the first quarter. President Biden's first order of business was a $1.9trl package that will send checks to over 120 million Americans while also bailing out states. With the ink barely dry on those checks, the new administration is now trying to push through a $2trl+ package for infrastructure and many other non-infrastructure related items. Coinciding with this historical fiscal stimulus, Fed officials have remained dovish by repeatedly expressing the need to keep rates low for as long as possible.

The actions by the Federal Reserve, and other central banks around the world, over the last 13 years have fundamentally changed the way we save and invest. With no return in "risk-less" assets, there has been a shift to pure risk that has been underwritten by the promise of a central bank that does not appear to care about bubbles. When market participants often say "compared to bonds, this particular investment is not that expensive," rationality about risk goes out the window. The party is in full swing. Investor debates of what a bubble looks like rages on in not only the U.S. equity and bond markets, but also cryptocurrencies, special purpose acquisition companies (SPACs), and property.

In 2020, global debt exploded by $20trl as countries and companies levered up in the name of free money. The Fed has not been able to take away quantitative easing in the 12 years since it initiated the first program, and maybe it will never be able to.

Portfolio Review

The Shelton International Select Equity Institutional strategy (2.72%) underperformed the benchmark MSCI ACWI ex U.S. index (3.5%) as international markets continued their stimulus-fueled ascent, this time led by value stocks that benefited from the belief in a global economic recovery.

The top five contributors in the quarter were ASML Holding NV (Deceleration), Techtronic Industries Co (Deceleration), CRH Plc (Maturity), Itochu Corp (Maturity) and Taiwan Semiconductor (Expansion). The biggest detractors were Valeo (Deceleration), Nomura Research Institute (Deceleration), Adidas AG (Deceleration), Daikin Industries (Maturity) and MTU Aero Engines (Maturity).

Regionally, the top contributors in the quarter were the Asia ex-Japan, Latin America, and Africa/Mideast while Europe, Japan, and Canada detracted most. Information Technology, Healthcare, and Utilities were the top contributors by sector, while Consumer Discretionary, Financials, and Energy detracted the most.

BUYs/SELLs

BUYS

Kimberly Clark de Mexico

As an affiliate of the U.S. company, Kimberly Clark Corp, Kimber has been able to maintain strong brand positioning and growth in the Mexican diaper, feminine care, toilet paper, and paper towel markets. The company's ability to adjust its strategy to changing market dynamics, such as higher input costs, along with a strong multi-channel growth strategy, including ecommerce, has enabled the company to take market share in Mexico. Further growth is being targeted in other parts of Latin America using the same strategy. A dynamic management team is constantly improving the operational and cost structure, and is achieving high free cash flow targets. We took advantage of a lower stock price in Q1 to take a position.

SELLs

Nokia Oyj

We purchased Nokia two years ago thinking that the Finnish telecommunications equipment maker would benefit as Nokia's management would successfully restructure its struggling business and western economies traded out rival Huawei gear for Nokia's. Even as the turnaround story took longer than we had hoped and required a change in management teams, the market share story is slowly playing out in some markets. However, the stock reached our target price in Q1 during the trading mania that took place in the U.S., and we used the opportunity to exit our position.

IMPORTANT INFORMATION

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For a complete list of portfolio strategy investments and their respective contribution for the preceding 12 months, and the methodology for calculating contributions, please call 1-800-955-9988.

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The MSCI ACWI ex USA is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed (excluding the United States) and emerging markets. Developed market countries include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. Emerging market countries include: Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and the United Arab Emirates. Net total return indexes reinvest dividends after the deduction of withholding taxes, using (for international indexes) a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties. It is not possible to invest directly in an index.

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