SHELTON CAPITAL MANAGEMENT

Shelton International Select Equity

QUARTERLY
Commentary
As of June 30, 2020

Executive Summary

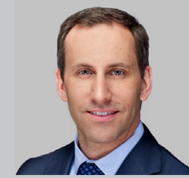
- International equity markets, as defined by the MSCI ACWI ex U.S. Index, staged a big rebound during the second quarter as investor confidence was restored following the near universal global answer to the epidemic with a "whatever it takes" stimulus response.
- The Shelton International strategy outperformed its benchmark as active management and new positions bought in the first quarter resulted in a less conservative approach.
- Emerging markets were the biggest gainers in Q2 led by Latin America which staged a partial rebound following a sharp decline in Q1. However, Latin American is still the worst performing region year-to-date.
- Hong Kong, as the worst performing major market in Q2, dragged down Asia following the region's outperformance in Q1.

Portfolio Performance

In the second quarter of 2020, the Shelton International Select Equity strategy (17.55%) outperformed the benchmark MSCI ACWI ex U.S. index (16.12%). Through the first half of 2020, the strategy (-5.03%) has outperformed the MSCI ACWI ex U.S. Index (-11.00%) by 597bps.

Portfolio Manager

Andrew Manton



Andrew Manton is the Portfolio Manager for the Shelton International Select Equity Fund.
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.

Market Review

The sharp snapback in equity markets in the second quarter ranks among the highest 3-month returns ever as investors cheered the seemingly endless deluge of stimulus from governments around the world. Ignored were the deteriorating relationship between China and the U.S., the aggressive posture of the Chinese Communist Party in taking advantage of the epidemic to strip the citizens of Hong Kong of their agreed upon human rights, plunging global PMI's, and the continuing spread of the COVID-19 virus. Global fiscal support along with the U.S. Federal Reserve's unprecedented ambling into the high yield corporate bond market has effectively signaled to investors that a floor has been inserted into the stock and bond markets. Valuation levels have essentially returned to pre-crisis levels and, in the case of the U.S. market, some measures of valuations have never been this high.

Europe

With interest rates well into negative territory and a bond-buying program already in place, Europe found itself searching for a response early in the pandemic that was outside the box. Unlike the U.S. Federal Reserve, whose first effort was to lower interest rates close to zero, the European Central Bank (ECB) did not have that option available. Instead the central bank president, Christine Lagarde, pleaded with the heads of its member countries to employ fiscal stimulus policies in an effort to ease the burden off monetary schemes. In March, however, the ECB announced a €750bln increase of their quantitative easing program, this time calling it the Pandemic Emergency Purchase Program (PEPP). This program officially allowed the ECB to expand eligible securities into private sector securities which was immediately met with contentious debate all over the Eurozone. In May, Germany's constitutional court ruled that the ECB overstepped its purview and that its recent actions were illegal under EU law. Despite the strong pushback, the ECB resisted the German court order and continued with the bond buying scheme. The European Commission was forced to step in and rebuke the German resistance and, under the pressure and perhaps seeing the continued deterioration in the Eurozone economy, the German court finally backed down.

Along with the enhanced purchase program, the ECB also introduced seven new liquidity measures in May aimed at helping banks distribute cash where needed. Just over a month into the program, they also discussed the desire to enhance the PEPP scheme given the need to roll over €2trl of existing debt and financing another €1.5trl of new issuance. A €600bln extension was announced in June which also increased the duration of the program into 2021 and reinvestment to the end of 2022. The central bank also extended the duration of the pre-crisis asset purchase program, which was already purchasing €20bln worth of bonds per month, indefinitely. Meanwhile the European Commission announced a €750bln Franco-German backed recovery plan that would last through 2027 and be channeled through existing EU programs. The commission is proposing new taxes and levies to fund the program. In total, the monetary response from Europe was €1.85trl in the first half of 2020.

With PMI's reaching unprecedented low levels throughout the Eurozone, individual countries dug deep into their fiscal coffers to help support their economies. Germany has promised stimulus amounting to €1.5trl, or 35% of their GDP, in a broad range of programs such as tax deferral, loan deferral, direct programs to small and medium businesses (SME's), job security, and local government investing incentives. France also responded with a wide-ranging program that includes unemployment support, tax deferrals, guaranteed bank loans, and direct support to certain industries. In total, they have promised over €400bln, or 14% of GDP, in fiscal support but the country's already fragile debt levels caused Fitch to downgrade their credit outlook to negative during the quarter. Italy, however, appears to be in a much more tenuous position after the virus ravaged parts of the country in the first quarter. The country turned on the stimulus bazooka in the second quarter and announced support in the form of cash to low-wage employees, mortgage payment suspensions, tax deferrals and credits for certain companies, and health system support. In total, the country offered just over €1trl, or 46% of GDP, in fiscal stimulus. Italy is expected to reach €500bln in financing needs this year and hit 175% debt-to-GDP, well above the EU's 60% debt-to-GDP permitted level. Despite this fiscal shock, Standard & Poor's reaffirmed Italy's credit rating in the second quarter to the market's surprise. The country even went as far as to plead with local retail investors to buy more Italian debt to support the country. With an abundance of fiscal support now in place in the Eurozone, investor's attention will now turn to the questions of whether or not the economy will be able to stand on its own as many of these stimulus measures get set to expire and how much more support might be needed.

UK

Boris Johnson was hit by the COVID-19 virus and briefly moved into the ICU in early April. The Prime Minister decided to extend the UK lock-down into May despite the pressure from businesses across the country as he saw the need to remain cautious about spoiling the containment measure already taken. Meanwhile the Bank of England (BOE) began to officially debate the merits of a negative interest rate policy and unconventional monetary moves such as buying riskier securities in their quantitative easing program. So far, promised fiscal stimulus is on the low side in Europe with approximately €450bln, or 16% of GDP, promised in the form of debt restructuring and loan deferral programs and tax credits for companies and individuals. GDP in the UK is now expected to fall by 8% in 2020.

China

The second quarter of 2020 was marked by significantly deteriorating relations between China and the U.S. Tempers were tested on both sides in April when White House officials announced they were exploring options for punishing Beijing including demanding financial compensation over its handling of the COVID-19 pandemic. President Trump appeared to be walking a fine line in dealing with the Chinese Communist Party (CCP) as the U.S. Presidential election draws near. The President needs China to abide by the Phase 1 terms of his trade deal by continuing to purchase farm goods on the one hand, but also appear tough on China. Beijing took aggressive action in the second quarter on multiple fronts in an effort to take advantage of both the global economic gloom caused by the pandemic, as well as, the upcoming presidential election in order to push its own agenda.

In early May, U.S. officials discussed ways to block key semiconductor equipment from being sold to China's Huawei and announced on May 18th that companies need to get official approval from the U.S. government before doing business with the Chinese company. Beijing responded by threatening to put U.S. tech and industrial companies on its "unreliable entity list" which would prohibit Chinese companies from doing business with the likes of Boeing. On May 21st, the U.S. Senate then passed a bi-partisan bill aimed at de-listing Chinese ADR's from U.S. exchanges. Chinese companies have long been exempt from the same accounting oversight standards as other companies on U.S. exchanges and this bill would finally address those loopholes.

On that same day, however, the CCP announced a proposed "National Security" law over Hong Kong that would essentially strip the territory of all its remaining freedoms that were afforded Hong Kong residents when the British passed Hong Kong back to the Chinese three decades ago. The original agreement promised a "one country, two systems" approach that allowed Hong Kong, a democratic state with basic human rights, to remain self-governed and protected under its own law until 2049. China has been slowly chipping away at these freedoms over the years, but this new law was aimed at stripping the Hong Kong people of their freedom of speech by making any kind of language that the CCP finds offensive punishable with a life sentence in prison. The law opens the door to the mass surveillance that is present on the Mainland and denies the right to protest, the right to speak freely, and the right to a fair trial. It follows the CCP's efforts to re-educate the people of Hong Kong by forcefully preventing Hong Kong bookstores the right to sell certain books seen as insulting to Beijing, as well as, dictating the curriculum of Chinese history classes in Hong Kong schools. The U.S. responded to this new law by immediately adding Chinese companies to their "entity list" that they feel were complicit in the human rights abuses against the Muslim minority in China in the past. On May 28th, the day that China officially passed the new law, Secretary of State, Mike Pompeo, officially declared Hong Kong no longer autonomous and eligible for the special trading privileges that the region enjoyed in the past. Beijing then ordered their state-run agriculture traders to cease purchases from U.S. suppliers which led to a mid-June meeting between both sides in Hawaii. However, the U.S. continued to announce sanctions, officially removed the special treatment status of Hong Kong on June 30th, and announced visa restrictions for some Chinese citizens. While these tit-for-tat announcements have largely been ignored by the markets thus far, we believe the unraveling of U.S.-China relations will lead to disruptions in trade and, ultimately, the equity markets and stock selection around this issue remains one of our key concerns.

This bold and aggressive behavior in China may be born out of the country's relatively resilient economic position as the country is now seen as the only major economy expected to deliver positive GDP growth in 2020. The Chinese central bank has opted for much smaller, yet targeted monetary response to the COVID-19 outbreak with bank and credit liquidity being the primary focus. The fiscal response looks to be along the same lines as the usual playbook with increasing infrastructure spending financed by off-balance sheet entities and local bonds in order to boost economic growth.

Emerging Markets

The monetary and fiscal stimulus response from developed countries was also used in developing economies where success to contain the virus has been mixed. On top of cutting base interest rates, South Korea announced three separate fiscal stimulus measures in the first and second quarters totaling $225bln, or 14% of GDP. Rather than implementing a mass lock-down, the country leaned on mass testing and trace efforts to contain the virus. The measures largely appear to have worked and GDP growth is expected to be flat in 2020. India is still struggling to contain the first wave of the virus and announced a much larger than expected fiscal stimulus plan in the second quarter that is equal to roughly 10% of GDP and is wide-ranging in its scope.

In Latin America, the response for both how to contain the spread of the virus and the how best deal with the economic fallout has been uneven. Brazil is still grappling with the ongoing spread with no clear direction from its leadership. While the health system continues to be overwhelmed in many areas, President Bolsonaro and his cabinet have become embroiled in several different investigation of impropriety. With a seemingly rebellious attitude towards the seriousness of the COVID-19 outbreak, the president has overseen a large deterioration in economic activity. Even with a fiscal stimulus package equal to approximately 10% of GDP, the outlook for Brazil's economic turnaround is perhaps the most uncertain in the developing world. Mexico, too, has been hesitant in their containment response and was late to require quarantine measures throughout Mexico City. Fiscal stimulus is complicated because of the large part of the workforce, approximately 40%, falling into the informal category. The country has so far only announced stimulus equal to 2% of GDP and economic output is now expected to drop more than 8% in 2020 – more than most of the developed world.

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The U.S.

Apart from China, the news in the U.S. in the second quarter was driven by further stimulus measures and the ongoing spread of the virus. The markets, meanwhile, began to ignore the latter while focusing squarely on the former and its ability to support growth. On top of the $2trl rescue package that congress passed in March, the Treasury quickly returned to Congress to ask for another $200bln for the small business program. Discussions about the need for another round of stimulus also began in April which may become much more partisan and therefore, difficult to pass. With the payouts to individual households long gone and the extra unemployment benefits set to expire at the end of July, investors are now expecting a new stimulus package to be introduced as a stopgap to the slack in unemployment. The size of this gap will be tested as the Paycheck Protection Program (PPP) rolls off and companies who hired back workers in order to have their loan forgiven will be faced with the question of whether or not they can still afford to keep them. A large infrastructure bill may also be in the works as a way to fill some of the slack but that may prove to be politically untenable.

Along with the huge amount of fiscal stimulus, likely to be equal to 20% of GDP or more when it is all over, the Federal Reserve was also highly active in the second quarter. In early April, it announced a raft of new and expanded programs to provide up to $2.3trl in loans to small and mid-sized businesses, local municipalities, and a backup to the PPP program. Following the Fed's announcement in March to buy corporate bonds, it chose to extend its investment grade corporate bond buying program to include "fallen angels" allowing them to delve into the high yield market. This raised the previous "whatever it takes" approach to a new level with a clear signal to investors that the "Fed put" was clearly in place. Debt and equity markets rallied on the back if this news while achieving one of the best performing quarters in history. By the end of the quarter, the Fed's balance sheet reached $7trl, up from $4trl in the first quarter and just $2trl after the original quantitative easing program that was used to shore up the Great Financial Crisis in 2008.

Closing Thoughts

The glut of stimulus that has been unleashed in the past five months appears to be achieving one of its objectives – putting a floor under debt and equity markets. Yet unknown is whether the measures will heal the underlying economy and employment market enough to allow the stimulus crutch to be removed. Equity markets have not waited for the answer but in fact appear to be pricing in a complete recovery in corporate profits and then some. In the U.S. equity market, the moral hazard unabashedly endorsed by the Fed has helped to push valuations to unprecedented levels, both in terms of forward price-to-earnings, as well as, the spread between forward P/E's of the U.S. markets and the rest of the world. This "stimulus bubble" is making individual security selection and valuation more complicated and we remain active in our search for opportunities. As we look toward the second half of the year, we do not see much of a scarcity of market moving events. The U.S. presidential election, the continued destabilization of U.S. China relations including responses to military threats in the South China Sea, the ongoing first wave of the COVID-19 virus, and possible second wave as it begins to hit parts of Asia are all matters that need to be closely monitored. We look forward to continuing to look for ways to add value for our investors.

Portfolio Review

The Shelton International Select Equity Institutional strategy (17.55%) outperformed the benchmark MSCI ACWI ex U.S. index (16.12%) as international markets found new confidence in governments' ability to stimulate economies out of the hole that had been formed by the global quarantine efforts in Q1. Growth stocks outperformed value again during the quarter as investors flocked to liquid technology companies and began to drive up multiples past pre-crisis levels. Active repositioning of the portfolio in, both, Q1 and Q2 resulted in further outperformance in the Q2.

The top five contributors in the quarter were Techtronic Industries Co (Deceleration), ASML Holdings (Deceleration), Nokia Oyj (Maturity), Valeo SA (Deceleration) and CRH Plc (Maturity). The biggest detractors were Thales SA (Expansion), Itochu Corp (Deceleration), AIA Group Ltd (Deceleration), Total SA (Maturity) and Ping An Insurance Group (Expansion).

Regionally, the top contributors in the quarter were Europe, Japan, and Asia ex-Japan, while Africa/Middle East, Latin America, and North America detracted most. Information technology, financials, and consumer staples were the top contributors by sector while materials, communication services, and healthcare detracted the most.

BUYs

New Oriental Education & Technology Group

New Oriental is China's largest private provider of educational services, with a focus on after-school tutoring. China's market for after-school tutoring is large, still under-penetrated and growing quickly - not surprising in a country where parents are willing to spend extra for educational purposes and where students are laser-focused on key public examinations. We think New Oriental's size and brand give it the scale necessary to recruit the best teachers, who in turn attract the most students. This will allow it to grow faster than the broader market, as it takes share from much smaller, often informal after-school tutors.

SELLs

Safran SA

We originally bought Safran because of its unique position as a supplier for narrow body aircraft engines. Together with its partnership with GE, Safran's engineering prowess allowed for an oligopolistic spot in this growing market. However, given Safran's exposure to Boeing's troubled 737 MAX plane, as well as great uncertainties around the demand for air travel the next few years due to COVID-19, and hence the demand for the 737, we believe the thesis has completely shifted and value creation is in question.

Thales SA

We purchased Thales, a French defense, aerospace, and telecommunications contractor, because of their product expertise and unique positioning as a home-based provider in a high barrier industry. This combined with what we saw as a growing industry as European governments were being pressured to increase their defense budgets. However, the company has struggled to execute on several big projects over the last year and has signaled that governments have been slowing their spending or choosing to buy used products instead of new in some key areas. With European government debt levels being stretched because of the pandemic, the outlook for rising defense budgets in the near term appears ominous. We decided to exit our position and focus on stronger positioned companies.

Total SA

The oil price collapse in March as COVID-19 pummeled demand and as the Saudis and Russians flooded the world with supply may prove to have been a great shifting point for the large, integrated oil producers that has long been in the making. Thanks to such supply and demand gyrations, refining spreads turned unpredictable and we think many of these problems will persist in the sector for some time. Even as Total's production price point is low overall, there are some bigger, more expensive projects that will have to be re-evaluated. We believe the business model for the large integrated players may be impaired for some time and we decided to exit the position in the quarter to focus on better positioned companies.

IMPORTANT INFORMATION

The stated opinions and views in the commentary are for general informational purposes only and are not meant to be predictions or an offer of individual or personalized investment advice. Such information does not constitute a recommendation to buy or sell specific securities or investment vehicles.

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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