SHELTON CAPITAL MANAGEMENT

Shelton Emerging Markets Fund

QUARTERLY
Commentary
As of June 30, 2021

Executive Summary

- Emerging Markets, as defined by the MSCI Emerging Markets Index, continued their ascent helped by artificially low interest rates and the hope that vaccinations will stem the economic pain the developing world is still experiencing.
- The Shelton Emerging Markets strategy underperformed its benchmark in the second quarter of 2021.
- Cyprus was the best performing country, followed by Poland and Hungary.
- Chile, Singapore, and Egypt were the worst performing.

Portfolio Performance

In the second quarter of 2021, the Shelton Emerging Markets Equity strategy (2.59%) underperformed the benchmark MSCI Emerging Markets index (5.05%) as lower quality, commodity-based stocks performed well in the beginning of the quarter as supply chains struggled to keep up with demand. With interest rates falling throughout the quarter, growth stocks took over the lead toward the latter days with the most expensive stocks again benefitting significantly. In the first full year of management by the Shelton International team (6/30/20 - 6/30/21), the strategy (48.6%) outperformed the index (40.9%) by 768bps.

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.

Market Review

While life began to normalize in much of the developed world during the second quarter, developing countries continued to grapple with the coronavirus and its numerous variants. Equity markets continued their seemingly unstoppable rise on the back of continued optimism about vaccination efforts and the flood of cash in the system from stimulus campaigns. This is helping to keep interest rates artificially low which, in turn, is making most bonds appear unappealing as an investment. It was the story of the bookends of the growth/value spectrum where inflationary trades, such as metals and mining stocks, along with the highest growth and most expensive stocks, all did well.

China

China posted a record GDP growth figure in April for the first quarter at 18.3% but growth expectation moderated by the end of the second quarter. June PMI fell each of the 3 months of the quarter while new orders and export growth appeared to stagnate in June. Inflation was a key topic early in the quarter and the government took steps to stabilize commodity prices, such as limiting speculation on open markets and putting in price controls for things like food and cotton. Inflation was certainly apparent in China's PPI figures for May, which rose 9% from the prior year – the highest rate in 13 years. However, the state controls appear to have helped at least stabilize prices of some commodities.

Notable comments came from the Vice Premier in April regarding de-risking some of the more worrisome areas of the Chinese economy. He called for curbing increases in implicit local government debt while reducing existing debt, which has become less transparent over time due to the nature of local debt. One of the issues has been local government trying to prop up struggling state-owned companies, which has created moral hazard or dependency on government debt in some cases. The Vice Premier also said that the housing market should be better regulated because it has been the main source of wealth creation in the country, leading to speculative purchasing in many cities and helping drive up home prices.

Already fearing a slowdown in economic growth due to demand moderation post-pandemic and some of the debt control measures, the government took some steps in the quarter to boost demand. In May, VAT and corporate tax deductions were put in place. Bank reserve requirements were also lowered in an apparent attempt to get more money flowing through the system. With debt moderation in focus, China's relatively high interest rate levels attracted foreign investors in the quarter helping strengthen the yuan in early June to levels not seen since 2015, just before the government took steps to devalue the currency. The yuan has since weakened slightly but this is an area the government is watching closely.

Relations with China for most of the world were further strained in the second quarter. China suspended high-level dialogue with Australia amid worsening relations. The G-7 meeting focused on the many growing threats and grievances with China such as the ongoing human rights violations of Uyghur Muslims and others in Tibet, the take-over and freedom squashing in Hong Kong, ongoing state-sponsored cyber theft, and the threat posed to Taiwan because of the Chinese claim to the island and much of the South China Sea. The Philippines, Malaysia, and South Korea all experienced provocative moves from Chinese military planes or ships that violated those country's territories.

The issue of Taiwan independence was a hot topic throughout the quarter. US senators visited the island in June which brought sharp criticism from Chinese authorities who called it a "vile provocation." Shortly after, the Biden administration announced it is launching trade and investment talks with Taiwan which further enraged the Chinese. Biden also met with other foreign leaders and publicly expressed concerns about an increasingly assertive China regionally and risks posed by actions in the South China Sea. China conducted bombing drills after a joint US-Japan statement was released with those talking points. In June, NATO warned that China's military ambitions pose "systematic challenges to rules-based international order" and that ties to regional neighbors such as Japan, New Zealand, South Korea, and Australia would be enhanced to strengthen cooperation around the growing threat posed by China.

The U.S. senate debated and passed a $250bln bill to boost competitiveness with China and highlighted the need to enhance advanced technologies including boosted support for the domestic semiconductor industry. In his speech at the 100th anniversary of the communist party, President Xi used strong language to suggest that any countries that meddle in China's internal affairs and threaten its goals, "will be crushed to death before the Great Wall of steel built with the flesh and blood of over 1.4bln Chinese people." He also reiterated his ambition to achieve reunification of Taiwan with the mainland while promising to crush any push for independence – adding further support for our concerns over this topic being the biggest geopolitical risk that exists today.

Other Emerging Markets

The coronavirus continued to wreak havoc in the developing world in the second quarter. India faced a large spike in cases and lockdowns were in place in some areas. Delhi, for example, was experiencing a doubling of cases every 5 days in April. New daily cases reached over 400,000 in April but started to fall toward 200,000 at the end of May, however, official figures are thought to be a small fraction of the actual cases and deaths. Families affected by the virus now face bankruptcy because of crushing medical debt. The Indian central bank expanded its QE program in the face of slowing growth due to the ongoing pandemic.

Asia and Africa saw a surge in cases, as vaccines were much more difficult to obtain. South Korea, Malaysia, Thailand, and Singapore all had to restrict public activity in the quarter. Taiwan, the country that was perhaps most lauded for its handling of the pandemic, saw a resurgence in cases and boosted fiscal stimulus as a result of forcing businesses to shut for a period. An ongoing drought in the country and erratic power supply further threated the already strained semiconductor industry.

Asia currencies are in focus as the Fed announced the acceleration of policy tightening. China's yuan fell on the announcement and long positions on other Asian currencies were trimmed. The tightening of developed markets' monetary policies in 2013 led to a rapid exodus of foreign investors from Asia causing bond yields to spike and forcing central banks to defend their currencies – central bank leaders in those countries are looking to avoid that scenario again.

Europe

Much of Europe was still facing increasing coronavirus infections at the start of the second quarter. Authorities in Germany struggled to control many outbreaks in the country. While the federal government looked to control the ability to impose lockdown restrictions where they wanted, demonstrators took to the streets to protest laws that would mandate strict curfews in areas with high infection rates. The WHO's European director noted that the region surpassed 1 million deaths in April and approximately 1.6 million new cases were being reported each week. The same month, the EU Health Commissioner cited a goal of getting 70% of adults in the block vaccinated by the end of summer which hinged on the ability to greatly speed up the delivery of vaccines. With the help of the U.S., deliveries were significantly increased throughout the quarter.

Not unlike the Federal Reserve, the European Central Bank (ECB) spent much of the quarter pushing back on notions that they do not know how to end the overly accommodative policies. There were rumors that the ECB would begin winding down its emergency QE program (PEPP) early as bond yields started to rise in May along with inflation expectations. For Europe, the main concern for regulators is that rising interest rates will hurt companies with weaker balance sheets and even more debt since the pandemic. This is a bigger risk for European banks because most corporate debt is issued by banks, as opposed to public debt markets where most of corporate debt in the U.S. is found. This has greatly complicated the discussion of how and when the ECB will conclude their emergency bond buying and what normalized policy will look like after that. Internal debates spilled out into the public in June, as some members offered differing opinions to media outlets. Several meetings were planned in June to iron out a new strategy.

Meanwhile, home prices in Sweden rose 20% year-over-year in April and the equity IPO market in Europe hit the highest level in 14 years in the first half of 2021. Further signs of the longer-term risks mounting as a result of the short-term monetary policies invoked in Europe and elsewhere. Italy's debt burden is expected to hit a record level as compared to its GDP this year at 159.8%. Its budget deficit is now also at an alarming height, 11.8%, while the EU waits to hear how and when the country intends to reign in both of those levels. If recent history is a guide, Italy will have a very difficult time returning to the levels mandated under EU rules.

U.K.

A study released in the second quarter highlighted the hit that London has experienced as a result of Brexit. Over 400 financial firms shifted activity and staff and over £1 trillion to EU counties over the last few years. Dublin has so far been the biggest beneficiary followed by Paris, Luxembourg, and Frankfurt. Meanwhile, the difficult situation with the Northern Ireland border has not been resolved and the UK continues to delay actions to resolve the issues. This prompted angry reactions from the European Commissions office and threats to take legal actions which could include tariffs. Trade between the UK and the EU fell by 23% in the first quarter of 2021 because of the disruption of Brexit. China overtook Germany for the first time, becoming the UK's biggest trading partner.

The Bank of England joined the Bank of Canada in announcing a cut to bond purchases as it looks to start to taper its QE program despite the ongoing challenges posed by the pandemic. Debates in the UK persisted most of the second quarter about extending the ongoing lockdowns that had been in place because of the spikes in new cases. Variants, including the delta version, have continued to plague the nation that has struggled to normalize after over a year of persistent lockdown measures. The government has so far supported the effected businesses and has promised to continue to do so if lockdowns are extended. The final reopening is scheduled for July 19th as of this writing.

The U.S.

The S&P 500 posted its second-best first-half of a year since the tech bubble. With huge inflows in equities, when inflows in the first 5 months exceeded all of 2020, and a continued by-the-dip mentality drove money into stocks. A JP Morgan report highlighted that the $340bln, or $17bln per week, that came into the market from January through May was almost double the previous record high back in 2017. In addition to all the stimulus related cash in the system, both in the financial system and personal bank accounts through stimulus checks, more investors than ever are borrowing to buy stocks as margin balances hit the highest level ever in the second quarter. This helped the equity risk premium fall to the lowest level in over a decade. This premium, the extra risk investors pay to own equities over bonds, reached approximately 290 basis points in the second quarter, down from approximately 400 basis points before the pandemic.

Two areas of recent high speculation, cryptocurrencies and SPAC's, seemed to have cooled off in the second quarter at least. Bitcoin saw a big sell-off in the quarter and now sits approximately 50% below its peak. The narrative around Bitcoin, and cryptocurrencies in general, as hedges against inflation was put to the test and the extra volatility (implied volatility at over 130 – or seven times more than the S&P 500), the weak logic around these ideas, and the speculative nature of the average investor was enough to prove that a proverbial floor to these investments is tenuous. The adoption of Bitcoin by El Salvador and a positive tweet from Elon Musk was not enough to reverse the downward momentum in Q2.

Inflation fears swept through the markets in the quarter. Bond prices fell early in the period only to recover towards the end with the idea being adopted that most of the commodity related inflation may be transitory. This idea will be tested as huge spending plans continue to evolve out of the Biden administration. April PCE numbers hit the second highest level since 1981. Meanwhile, the Fed is closely monitoring the wage inflation levels which are, of course, heavily affected by the stimulus policies in place which, in turn, are one reason for the lack of interest in some workers returning to the workforce. If those measures end in September, as they are supposed to, the workforce will start to shift again. Other pandemic related deferral benefits, such as student loan repayments and rent, are also expected to end in the third quarter, further complicating the outlook.

The Federal Reserve meanwhile has been busy conveying to market participants that a rise in prices and bond yields would be a positive scenario. They then announced in June that tapering will start sooner than previously thought and rate hikes may come as soon as 2022. Pressure is building on the Fed as inflation and real estate bubble risks percolate. It was revealed that the Fed bought 47% of MBS issuance in the fourth quarter adding to the discussion around their outsized role in various markets. A slowdown in the rate of change of central bank purchases has received attention given the outsized role the liquidity tailwind has played in the rebound from the pandemic bottom in March of 2020. Bank of America noted that while central banks purchased $1B of financial assets every hour since February 2020 (and $21T since the Great Financial Crisis), QE is expected to fall to $400B in 2022 from $3.4T in 2021 and $8.5T in 2020.

The effects of the ultra-loose central bank policies, especially from the U.S. Federal Reserve, are starting to become much more apparent in the form of bubbles in real estate, equities, and highly speculative investments such as cryptocurrencies. As everyone gets more levered into these lower interest rates – government and corporate debt levels are at all-time highs – central banks are ultimately increasing the long-term risks in an effort to alleviate short term pain in the markets, while greatly altering price and risk signals. In a sense, central banks may have forever changed the way we think about saving and investing because of the uncertainty with which they might be able to unwind the massive support and the moral hazard that has led to complacency. We believe that the Fed, and other central banks, will find it extremely challenging to achieve market stability in the face of withdrawing support.

Portfolio Review

The Shelton Emerging Markets Equity strategy (2.59%) underperformed the benchmark MSCI Emerging Markets index (5.05%) as international markets continued their stimulus-fueled ascent benefitting both growth and value stocks.

The top five contributors in the quarter were eMemory Technology (Taiwan), Regional SAB (Mexico), Xinyi Solar Holdings (China), Accton Technology (Taiwan) and Arco Platform Ltd (Brazil). The biggest detractors were New Oriental Education & Technology (China), Autohome (China), Haier Smart Home (China), PT ACE Hardware (Indonesia), and PT Bank Rakyat (Indonesia).

Information Technology, Consumer Discretionary, and Consumer Services were the top contributors by sector, while Financials, Energy, and Industrials detracted the most.

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The MSCI Emerging Markets Index captures large and mid cap representation across 26 Emerging Markets (EM) countries (Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates). With 1,403 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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