SHELTON CAPITAL MANAGEMENT

Shelton Emerging Markets Fund

QUARTERLY Commentary

As of September 30, 2021

Executive Summary

- Emerging Markets, as defined by the MSCI Emerging Markets Index, dropped as interest rates rose around the world.
- The Shelton Emerging Markets strategy outperformed its benchmark in the second quarter of 2021.
- Uruguay was the best performing country, followed by Czech Republic and Colombia.
- Brazil, China, and South Korea were the worst performing.

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. at Chicago.

Portfolio Performance

In the third quarter of 2021, the Shelton Emerging Markets Equity strategy (-3.25%) outperformed the benchmark MSCI Emerging Markets index (-8.09%) by 484bps as prudent stock selection and active management in the quarter mitigated the decrease of the fall. With interest rates rising throughout the quarter, high valuation growth stocks took a relatively large step back. The strategy (44.89%) has outperformed the index (29.09%) by 1580bps since it was taken over by the Shelton International team on 6/26/20.

Market Review

The annualized flows into global equity markets in 2021 is bigger than the cumulative inflow of the last 20 years. This was one of the biggest data points of the 3rd quarter and, thanks to the flow calculators at Bank of America, the huge distortions in the equity markets that we have witnessed over the last year have now been quantified and put into context. The massive stimulus programs from governments and central banks across the world have created so much liquidity that has resulted in over $1 trillion flowing into equity markets this year alone. Of course, equity markets are not the only ones that have been impacted. Everything from bonds and real estate prices have soared while new, inscrutable and hollow markets such as cryptocurrency and crypto art have been developed where speculation of the worst kind has flourished. The combination of artificially low interest rates and government programs in the U.S. helped to push up home prices 20% higher in July over the prior year according to the S&P/Case- Shiller index.

Executives at all types of companies discussed how inflation was affecting their business and how they would continue to pass on costs during 2nd quarter earnings calls. The sudden, stimulus induced demand along with a myriad of supply chain disruptions continue to wreak havoc in many industries and are helping to push up prices from raw materials to shipping. Although the question of whether the current spike in prices is transitory or not is valid, executives are certainly not waiting around to find out. This is all playing out at the same time as central banks across the world are beginning to roll back quantitative easing programs and government fiscal stimulus campaigns are expiring. Markets began to react to this new dynamic in the 3rd quarter, with the main result being higher volatility.

China

China, along with a handful of other countries in the Asian and Australasian regions, believe they can irradicate COVID-19 completely within their borders. They have been creating policies around this so-called "Zero COVID" belief that are helping to exacerbate the ongoing supply chain issues by shutting down entire regions at a time. In August, China partially shut the world's 3rd busiest port because of one worker testing positive for COVID-19. In September, the government locked down Xiamen, a city of 4.5 million people and a manufacturing hub, after a dozen cases were detected.

Meanwhile, the report on the origins of the COVID-19 virus ordered by President Biden's administration turned out to be a nonevent. The President admitted his team was unable to reach a conclusion and essentially blamed China for their refusal to aid in the investigation. However, an investigative news organization called The Intercept, through the Freedom of Information Act, was able to collect over 900 pages of information that details how the U.S., through the National Institute of Health and EcoHealth Alliance, was complicit in funding so-called gain-of-function research at the Wuhan Institute of Virology – something officials in both countries have denied.

China's Zero COVID policies helped the country deliver disappointing economic numbers throughout the quarter, pointing to a sharper than expected slowdown. Official manufacturing PMI in September showed the first contraction since April of 2020 and corporate profits slowed to a 10% year-over-year growth rate in August from 16.4% a month earlier. Growth in trade numbers were mainly due to price increases. Data showed that Chinese exporters had pushed dollar prices higher by 13% in August, the fastest pace since 2005. Input costs rose so much that the government stepped into the commodity markets to set prices and release supply from the Strategic Petroleum Reserve. For its part, the Chinese Central Bank was forced to balance this slowing economic situation with the rising prices and imbalances in other areas of the economy, such as alarmingly high debt levels for local governments and property investors.

In July, it was reported that local governments were scrambling to set up rescue funds to bail out State Owned Enterprises (SOE's) in response to a flurry of high-profile bond defaults across the country. In September, Goldman Sachs published a report that concluded the total unofficial local government debt held in hidden financing vehicles was equal to ¥53 trillion (USD 8.2 trillion) or approximately half of Chinese GDP. Complicating this situation are the central government's attempts to slow land sales by local governments to cool the overheated property market. Land sales generated ¥8.4 trillion (US$1.3 trillion) in revenue in 2020, close to the ¥10 trillion they earned from all other sources including sales, personal, and property taxes.

China's debt trap and overreliance on real estate were brought to the forefront in the 3rd quarter. For much of the last two decades, real estate has been the main store of wealth in China, and the sector has been an important driver of economic growth. Harvard economist, Ken Rogoff, pointed out in a paper

last year that the real estate and construction industries in China accounted for approximately 28.7% of GDP in 2016 and is probably higher today. When comparing this to the pre-financial crisis peak in the U.S. in 2005, when real-estate related activity made up approximately 19% of GDP, it very clearly shows how sensitive and dependent the Chinese economy is to this industry. The only other country to come close to the Chinese level of dependency on real estate was Spain in 2006 when real estate related activity reached close to 28.7% of GDP. Approximately 27% of Chinese bank loans are real estate related and 18% of the urban labor force was employed in real estate. Additionally, housing wealth is a much bigger share of overall wealth in China at roughly 78%, compared to 35% in the U.S.

The cycle of wealth concentration into the real estate market has led to the classic signs of excess. Price increases in Tier 1 cities have risen six-fold since 2002, compared to just 80% in the U.S. real estate market. On a price-to-income basis, Beijing, Shanghai, and Shenzhen are greater than 40x, compared to 22x in London and 12x in New York. In 2008, first-time homebuyers made up 70% of the market, 25% of purchasers were buying a second home, and 5% owned two or more homes or apartments. In 2018, those numbers were radically different as only 13% were first time purchasers, 75% had one home already, and 22% had two or more homes. Chinese citizens have been buying up apartments and sitting on them as investments. This has skewed the vacancy rates in most cities because many of the so-called vacant apartments are just investments that are not being used by owners. Today, 20-25% of Chinese housing stock is estimated to be empty.

With local government's encouragement and the central government's passive stance on the industry, real estate developers saw less risk in adding more leverage over the years. China Evergrande Group is just the biggest and messiest on the list of over-levered real estate developers. Over the years we have watched as their balance sheet became more and more levered. Net debt-to-equity was well over 200% in 2017 while EBITDA less CapEx barely covered interest payments on debt for most of the last 5 years – two very alarming metrics considering the scale of the company's liabilities, which are equal to approximately 3% of China's GDP. It seemed that the party was beginning to wind down last year when the central government finally took notice and issued rules to limit leverage in the industry. This forced Evergrande and others to get more creative and issue debt off their balance sheets. However, the government's recent aggressive steps to cool the property market were finally enough to break the balance sheet of the massive developer. We believe Evergrande will ultimately be a "controlled failure" where the government helps to wind it down, publicly punish the executives, but make good on individual's home buyers' deposits on unfinished apartments. The fallout will be the loss of payments owed to the many contractors and employees who ultimately lose their job.

The news shifted from Evergrande to the brewing power crisis during the final week of the quarter. In another balancing act, the Chinese government has been trying to cut emissions in the face of rising demand for electricity. In doing so, the country has been reducing its coal mining output which ultimately has led to surging prices. To control the overall power production costs, the government has been ordering a crackdown on power consumption by forcing manufacturers to curb activity. Apple, Tesla, Intel, Qualcomm, and Nvidia are just a few of the companies whose suppliers have had to reduce output. Ultimately, the rising energy prices will get passed through the supply chain from manufacturer to end buyers adding yet another pressure point to consumer inflation.

Elsewhere, China took advantage of the botched U.S. withdrawal from Afghanistan to assert itself into the massive gap left while also antagonizing countries that depend on the U.S. for protection. China was among the first countries to announce it would recognize the Taliban if Kabul was overtaken, a major shift from its policy in dealing with the extremist in the 1990's, and to see this as a potential opportunity to expand China's "Belt and Road" program in the region. China also took the opportunity to directly remind Taiwan and Japanese leaders that this was an example of why they should not rely on the U.S. for protection.

Despite this aggression, the U.S. appeared to be making diplomatic concessions in order to bridge the widening divide between the two countries. Presidents Biden and Xi held a 90-minute phone call, which much like Secretary of State Blinken's meeting earlier in the year with his Chinese counterparts, proved to be ineffectual. Commerce Secretary Gina Raimondo, under pressure from many U.S. corporations, also made comments about wanting to increase business ties with China. However, the two countries do not seem to be able to talk about any mutual interests without China demanding the U.S. change its stance on several topics. The current Special Presidential Envoy for Climate, John Kerry visited China to discuss climate change cooperation, but the Chinese side used the occasion to lecture Kerry and demand that the U.S. respond to the two lists of grievances that were presented to Deputy Secretary of State Wendy Sherman when she visited Tianjin in July. Among the demands, the extradition request for Huawei's CFO, Meng Wanzhou, was to be revoked. The U.S. conceded that demand and Meng was released by Canadian authorities in September.

The biggest diplomatic jockeying, however, has revolved around the issue of Taiwan independence. Provocations increased in the 3rd quarter from both countries regarding Taiwan. China views Taiwan as a breakaway province that still belongs to the mainland and requires other countries to forgo direct diplomatic contact with the island while also warning Taiwan not to commit any explicit act of independence. So, when Taiwan made a bid to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) trade pact in September, it was crossing a clear red line in the eyes of the Chinese government. China's immediate reaction was to also bid for membership with the hopes that they would be admitted first and then be able to block Taiwan's bid. As a further warning to the island, China also stepped up its ongoing war game provocations by sending military jets that violate Taiwan's air defense zone.

The U.S. was said to consider crossing another red line by allowing Taiwan to officially change the name of its de facto embassy in Washington to include the name, "Taiwan." Chinese government officials took this action very seriously and warned of a "severe military and economic response" if the name change was allowed. The rarity that China uses the threat of military force is a clear indication of just how serious the country is taking this position. Further enraging the Chinese, the U.S., U.K., and Australia announced a pact meant to enhance each country's security in direct response to the threat posed by China. As part of the agreement, the U.S. and U.K. will share nuclear submarine technology with Australia so the country can build a more advanced naval defense. This follows other diplomatic trips and meetings by the U.S. with other nations in the Asian region meant to renew and strengthen relations, especially as it relates to projecting a unified front in dealing with China. The Chinese view this tactic as encirclement and have responded with direct threats to the individual countries.

Military training and war games across the region escalated throughout the 3rd quarter. Air defense zone violations in Taiwan from Chinese fighter jets were a daily event and the number of jets used in the provocations increased throughout the quarter. In August, the Chinese sent jets just minutes before

the Taiwanese military began scheduled exercises, then sent 19 nuclear bombers into Taiwan airspace in September. Joint military exercises were made by several nations in the region which was matched by China, Iran, and Russia announcing a joint naval drill, that will take place later in the year, to show support for Iran. The increasing scope of military exercises and war game analysis from all sides, along with the obvious threat felt by the Chinese government over their claims of Taiwan sovereignty, is of particular concern. This issue continues to be the greatest geopolitical risk in our view.

Other Emerging Markets

India reported GDP growth in the second quarter of 20%, but fell just short of the pre-pandemic level. As COVID-19 continued to spread in waves through most of the world, especially developing countries, something very interesting happened in India in 2021. While it is no secret that case levels in India had been considerably underreported due to testing availability, certainly in 2020, testing throughout the country has increased considerably over the last 15 months. In March and April of this year, cases began to spike and reached roughly 400,000 new cases per day in early May, much higher than the peak of about 300,000 cases per day in the U.S. back in January. However, new daily cases very quickly began to decrease throughout May and by the end of June, they were down to approximately 50,000 new cases per day. On September 30th, new cases in India were just 27,300 compared to 120,822 in the U.S. on the same day - a clear disparity of results given the U.S. population is approximately a quarter of India's and the vaccination rate in India is only a fraction of the U.S.' currently and is not expected to reach 50% until the end of 2021. Much needs to be done to discern the precise reason for the large drop in cases in India but there is early evidence of mass usage of antivirals for both prophylaxis and as treatment of COVID-19 in the country starting in late 2020 – a practice unique to a handful of developing countries. The obvious result has been control of the spread of the virus which, in turn, has allowed for the reopening of the Indian economy.

Other developing countries have been struggling to figure out the proper response to the spread of the virus. Malaysia, home to some critical companies in the semiconductor supply chain, chose to impose drastic lockdowns in parts of the country as cases developed. Vietnam, Indonesia, and Thailand have also experimented with lockdowns which have had a profound effect on the apparel industry and the many industries that rely on semiconductors.

In politics, Thailand's Prime Minister survived 2 no-confidence votes but sits uneasy as protestors continue to demand his resignation based on the ineffectiveness of his response to the pandemic. In a country known for coups, the opposition party will be looking to unseat the PM one way or another. Malaysia, meanwhile, named a new Prime Minister in August who then issued the country's largest ever five-year development plan that calls for an average GDP growth rate of between 4.5%-5.5%, compared to just 2.7% from 2016-2020.

The standout emerging market continues to be Taiwan where the central bank is now forecasting a 6% GDP growth rate for 2021 and a modest 3.5% in 2022. Strong exports have been the primary driver despite a water shortage hampering industrial production for most of the year and waves of COVID-19 throughout the country. The strong economy has given the central bank confidence to consider raising interest rates along with developed countries such as the U.S.

Europe

Germany voted the Social Democrats to lead the country, narrowly beating out Angela Merkel's Christian Democratic Union party. A coalition government will have to be formed which could take until the end of the year, but there is hope that a balance between the major parties can be found after Chancellor Merkel steps out of the political spotlight. One of the biggest questions going forward will be around whether the fiscal conservative economic policies in Germany will continue. There has been a call by some politicians to expand Germany's balance sheet in order to achieve higher growth levels.

In economic news, German retail sales fell by 5.1% in July after gains in the previous two months. Manufacturing PMI across the Eurozone also hit a six-month low in August with supply chain issues partially to blame.

Inflation concerns and tapering comments by the U.S. Federal Reserve put pressure on European Central Bank officials to update rate guidance. Minutes from their July meeting showed officials had extensive debates over their new guidance of promising an even longer period of unchanged or lower rates. However, by September, some officials began to talk down that narrative and admit that policy normalization should begin if the economy continues its recent recovery and inflation remains elevated. Bond investors viewed this as the possible end to the ECB's emergency bond buying program and sold off bonds in most countries. Meanwhile, Norway became the first country in the region to raise interest rates, with another hike expected in December.

U.K.

The U.K. demanded a renegotiation of Brexit to which the E.U. promptly rejected in July. Issues around the Northern Ireland border have proven to be incurable, and negotiations now look like they will continue for years. In other political news, Prime Minister Johnson was under fire for his plan to raise taxes on employees, businesses, and shareholders to pay for the increased health and social care administered by the government over the last year.

Like most other central banks, the Bank of England is trying to balance high inflation rates with accommodative interest rate levels so that extra government spending can persist if needed. However, officials in the U.K. are pushing back on non-essential fiscal spending with an eye on the effects a future rise in interest rates may have on debt service ability. BoE member Saunders and UK Chancellor Sunak made speeches in the 3rd quarter that warned of continued spending and the need to normalize monetary policy.

The virus and Brexit were the two biggest topics for much of the quarter in the U.K. until rising energy prices started to grab headlines. Panic buying at gas stations over supply concerns resembled images of the 1970's oil crisis. In late September, it was estimated that 50-90% of stations in London had run dry. Brexit rules were complicating the ability of supply arriving from Europe putting further pressure on the government to press the E.U. for some relief before winter on the deal that was struck last year.

The U.S.

The U.S. Federal Reserve responded to pressure to address inflation fears across the economy with a clearer plan on tapering its emergency bond buying program. In what appeared to be a more hawkish stance, Fed Chairman Powell suggested tapering of the program would begin as early as November of this year and end the program towards the middle of 2022. Complicating this narrative was the loss of Fed Presidents Kaplan and Rosengren who resigned after pre-announcement stock trading activity was revealed for both officials. Both presidents were hawkish-leaning and their replacements may shift the discussion toward other direction. Still, most Fed officials still seem to be excusing the pricing pressures throughout the economy as transitory while

claiming their goal of "full employment" has not been reached. The lack of public acknowledgment around the fiscal and monetary policy conflicts related to employment has proven to be a dangerous tactic.

The Fed has let asset bubbles proliferate to reach an employment goal over which they have little influence, especially since its interest rate policies are being counteracted by fiscal policies that are not encouraging people to seek out jobs. If the Fed is so sure the observed inflation is transitory, by that same logic, wouldn't the higher unemployment also be transitory? And how do 0% interest rates help get people back in the workforce exactly? What the Fed has done is just fueled the appetite to add leverage everywhere, from government to corporations, further increasing liquidity to an already over stimulated system. Home prices in the U.S. rose by 20% in July from a year earlier according to the Case-Shiller index. Even if more people get back into the work force, they are going to have a much more difficult time affording rent or buying a home.

In the U.S., just 5 stocks accounted for 1/3 of the total return of the S&P 500 index over the last 5 years through August, according to S&P Dow Jones Indices. The technology sector has been the biggest beneficiary of low interest rates and souring valuations. As details of the Fed tapering emerged and bond yields began to rise in anticipation, tech stocks suffered the most. It will be interesting to see how higher rates along with antitrust efforts toward the biggest tech stocks will affect the index going forward.

Aside from the closing liquidity tap from the Fed, fiscal benefits that provided liquidity to the system such as extra unemployment benefits and the student loan and rent moratoriums are all set to expire by January 2022 at the latest. Just as this massive, combined stimulus added to the upside for stocks, it will no doubt affect stocks as it is pulled back – something we got a glimpse of in the 3rd quarter in the form of higher volatility. Added to this are a myriad of higher tax initiatives currently being debated in the Congress that will further erode productivity.

Portfolio Review

The Shelton Emerging Markets Equity strategy (-3.25%) outperformed the benchmark MSCI Emerging Markets index (-8.09%) as the stimulus programs began to unwind and interest rates began to rise around the world.

The top five contributors in the quarter were eMemory Technology (Taiwan), Chailease (Taiwan), Voltronic Power Technology (Taiwan), Dentium Co (S Korea), and HDFC Bank (India). The biggest detractors were New Oriental Education & Technology (China), Arco Platform (Brazil), Sul America SA (Brazil), Accton (Taiwan), and Ping An Insurance (China).

Consumer Discretionary, Communication Services, and Information Technology were the top contributors by sector, while Energy, Materials, and Financials 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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