QUARTERLY

Shelton Emerging Markets Fund

Commentary

As of June 30, 2022

Market Commentary

Stagflation: Worried about the stag, don't forget about the 'flation

After inflation dominated the investment headlines in the first quarter of 2022, the second quarter saw a shift in focus. With the commencement of central bank rate increases across most of the English-speaking economies, and expectations of tightening across much of the rest of the developed world, markets began to focus on the economic cycle or specifically, will the increase in rates cause a US or global recession?

	6/30/22	5/31/22	4/29/22	3/31/22	2/28/22	1/31/22	12/31/21
Federal Funds Target Rate	1.75	1	0.5	0.5	0.25	0.25	0.25
Bank of England Official Bank Rate	1.25	1	0.75	0.75	0.5	0.25	0.25
Royal Bank of Australia Target Rate	0.81	0.31	0.06	0.09	0.05	0.05	0.04
Bank of Canada Overnight Lending Rate	1.5	1	1	0.5	0.25	0.25	0.25

Investors seem to be satisfied with central banks activities. Breakeven rates in the US, reflecting inflation expectations for 3-, 5-, 7-, or 10-years in the future, show that once the tightening cycle began, breakeven rates promptly began to fall, returning to levels of mid to late 2021 by the end of the quarter.

	Dec-20	Dec-21	Mar-22	Jun-22
US 2 Year Breakeven Rate	2.01	3.22	4.41	3.29
US 5 Year Breakeven Rate	1.97	2.91	3.43	2.62
US 7 Year Breakeven Rate	2.02	2.78	3.00	2.36
US 10 Year Breakeven Rate	0.91	1.51	2.34	3.01

Portfolio Managers

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Commodity prices, caught in a tug-of-war between inflation and growth, have rolled over since peaking in early June. From the beginning of the year through May 31st, the Bloomberg Commodities index rose 38.9%. It fell 11% in the month of June. Inflation continued to rise, reaching 9.1% in the US and the UK, 8.6% in the Eurozone and 2.4% in Japan (high by Japanese standards).

	Jun-22	Mar-22	Dec-21	Sep-21	Jun-21	Mar-21	Dec-20
US CPI YoY Change	9.1	8.5	7.0	5.4	5.4	2.6	1.4
Euro Area All Items YoY Change	8.6	7.4	5.0	3.4	1.9	1.3	-0.3
UK CPI YoY Change	9.2	6.2	4.9	2.8	2.1	0.6	0.5
Japan CPI YoY Change	2.4	1.2	0.8	0.2	-0.5	-0.4	-1.2

With the Federal Reserve ramping up the pace of tightening to perhaps an unprecedented 100 basis points in the July meeting, it is a good time to dig into the underlying causes of inflation, and what they forebode for the future.

Demand Side

The cause that gets the most attention when discussion on inflation in the US is the massive stimulus provided during the pandemic. Fiscal stimulus consisting of direct payments to individuals is far more inflationary than monetary stimulus provided by changes in central bank overnight lending rates. A greater portion of fiscal stimulus is spent by the recipients, increasing aggregate demand and price inflation, while monetary stimulus is invested and generally contributes to asset price inflation.

Pandemic related fiscal stimulus from the US federal government is at an end, but other fiscal stimulus continues 'on the down low' in the name of populism. Thanks to the growing economic inequality, exacerbated by the COVID pandemic, populism has gained popularity in many Western economies worldwide. Much of the stimulus in the US went into state coffers where they are administered by politicians keen to buy votes in the fall election. 14 states in the United States are planning on offering some type of cash payment or refund to their residents. Ironically, while the federal government is tripping over itself to figure out ways to soften inflation, state governments are strengthening it.

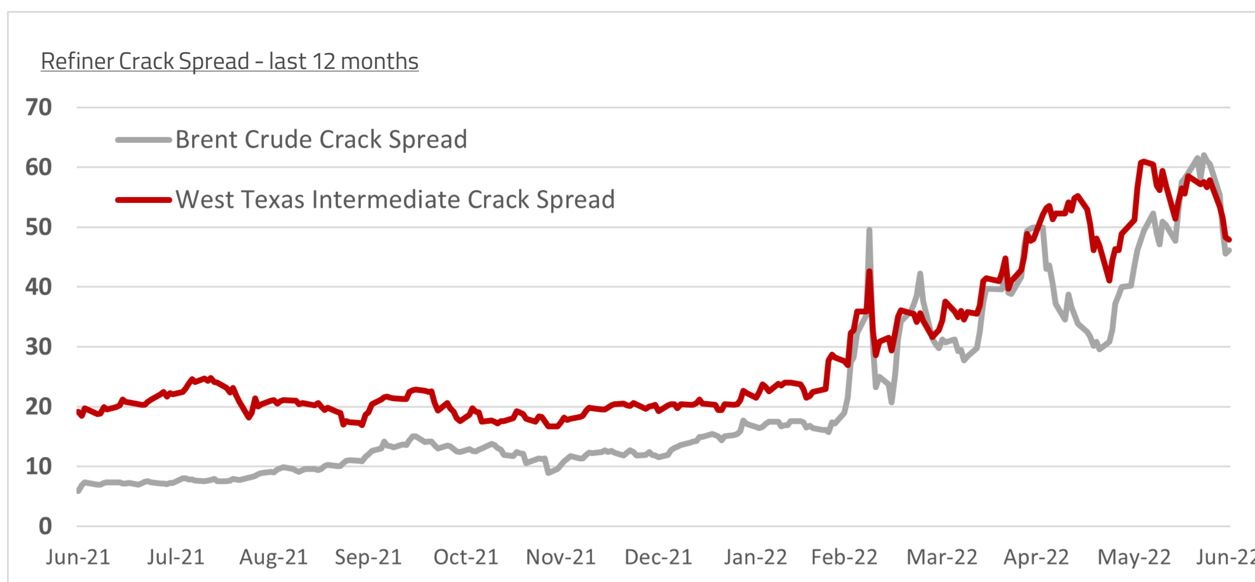
Supply Side

While central banks can use overnight rates to affect these sources of demand, monetary policy has less effect on supply-based sources of inflation. Supply side inflation comes from more insidious geographic, demographic, and geo-political sources.

Potentially the most important long-term inflationary force is the steady movement toward de-globalization. As a second-order effect of American populism, the US middle class has grown tired of subsiding the developing world, and pushed politicians to enact policies, such as tariffs, to shelter domestic industries from cheaper foreign labor. Concerns over the risks of overstretched supply chains has led many firms to look to re-shore or near-shore current operations. TSMC is discussing a new fab plant in Arizona, and Apple has moved their production of AirPods from uncertain China to authoritative but stable Vietnam.

Globalization has been the constant force behind the deflationary environment of the past few decades. Its reversal, while gradual, would challenge the 2% inflation developed world consumers have grown accustomed to. Referring to the table of breakeven rates, while the shorter 3-, 5- and 7-year rates have all reversed their earlier increases, the 10 year remains in a stubborn uptrend.

Climate change is another inflationary force. Put simply, if you move from inexpensive but pollutive sources of energy to clean but more expensive sources of energy, the prices go up. Gasoline prices in the US are higher not just because the price of oil has gone up, but because a shortage of refining capacity has driven up the cost of gasoline versus oil - otherwise known as the 'crack spread' - by 30%. Oil prices have almost returned to the levels before Russia invaded the Ukraine, but gasoline prices remain stubbornly high.



Refineries are an expensive investment, and few downstream energy firms are willing to make such a capital commitment if they see an uncertain future for fossil-fuel based energy resources. Governments are equally unlikely to approve such projects.

Overseas, sources of inflation differ. The Russian invasion of the Ukraine released a host of inflationary forces. While oil prices have returned to close to where they were before Russia attacked, regional natural gas prices have been very different. Dependent on Russian sources for their natural gas, Germany has experienced twice the increase in gas prices as we have seen here in North America and could go higher. On top of this, Russia and Ukraine are large exporters of food, much of which goes to other European nations. Despite weakness in the overall commodity structure, it could be a long winter.

At the same time, given the economic diversity of the European Currency Union, the ECB has less flexibility to raise rates lest they plunge one of the weaker economies into a deep recession. They also have less need to – with the range of geopolitical events raging at their doorstep, excessive demand is not their biggest problem.

Requiem for Disinflation

The saying goes: the best cure for high prices is …high prices. The modern global economy is far more flexible and adaptive than ever before, but in some ways, it is more fragile as well. Decades of peaceful prosperity have created an efficient and deeply interrelated global economy, but the conflict in Eastern Europe reminds us that this period was the exception, not the norm, of human history.

While current measures of inflation have likely peaked, the foundations of the past few disinflationary decades are likely past as well. If higher levels of inflation are here for the foreseeable future, that would be a regime change in the investing environment, and we must adjust our perspectives and methods of investing to reflect that reality.[1]

[1] Please see out 1st quarter commentary for ideas and perspective on investing in an inflationary environment.

2Q 2022 Shelton Emerging Markets Fund Commentary

Shelton Emerging Markets Fund

The Shelton Capital Emerging Markets Fund declined by -14.80%, underperforming the MSCI Emerging Markets Index performance of -11.40% by 3.40%.

China's equity market rallied strongly in the second quarter, rising over 3% when emerging markets in general were down over 10%. After 15 months of steady decline, internal developments gave investors reason to return. The central government pulled back from some of their previous threats to intervene in equity markets. Property markets continued to find a bottom since mid-March, and some progress in the battle against COVID allowed the government to relax lockdowns and help manufacturers get back to business. We remain underweight China, given concerns about the government and the long-term consequences of challenging demographics. While we tactically reduced our underweight, the strength of the rebound served as a headwind to the fund and substantially all the underperformance in the 2nd quarter can be attributed to this underweight.

The best individual performer in the portfolio was Dentium, a Korean supplier of dental implants, up 18.8% during the quarter. The firm has price competitive products and stands to see a recovery in revenues as Chinese markets reopen. Voltronic, Taiwanese producer of power supply products also delivered positive returns in a difficult market. The largest underperforming position was Regional SAB de CV, a small bank in Mexico. Despite a difficult quarter, ROE and margins are improving, and the efforts of management to control asset quality are likely to bear fruit.

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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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