SHELTON CAPITAL MANAGEMENT

# Shelton International Select Equity

QUARTERLY
Commentary
As of December 31, 2019

## Executive Summary

- International equity markets, as defined by the MSCI ACWI ex U.S. Index, rallied in the fourth quarter as expectations for the U.S. and Chinese to come to a trade agreement rose and the persistent low-rate environment drew inflows into the equity markets.
- The Shelton International Select strategy failed to keep pace with the benchmark and underperformed for the first time in 2019.
- Asia, led by China, was the best performing region, as news of a "phase one" trade deal came to pass.
- The UK and Canada were the worst performing regions in the fourth quarter.

## Portfolio Performance

In the fourth quarter of 2019, the Shelton International Select Equity Institutional strategy (6.38%) underperformed the benchmark MSCI ACWI ex U.S. index (8.92%), underperformed the MSCI ACWI ex U.S. Growth index (9.58%), and underperformed the MSCI ACWI ex U.S. Value index (8.24%).

## Market Review

International markets finished sharply higher in the fourth quarter of 2019 as the United States and China made significant progress towards a so-called "phase one" trade agreement, the UK made strides towards an all-but-certain Brexit early in 2020, and the outlook for the U.S. economy remained positive despite mixed economic data from the world's other major economies. Though global growth continues to slow and risks remain skewed to the downside, the easing campaigns undertaken by central banks around the world continue to drive yield-hungry investors into equities.

The Eurozone economy finished 2019 amidst its deepest slump in six years. Job creation in the region is now at a five year low, and December's Eurozone Manufacturing PMI survey declined to 45.9 from 46.9 in the prior month, the eleventh straight monthly decline. Germany continues to exemplify the general weakness in the region as November's business activity survey posted a decline for the fourth straight quarter and industrial production registered an unexpected 1.7% year-over-year ("YoY") decline in October, which provided evidence of weakness in capital goods orders outside of the automotive space. Even the French economy, in which manufacturing had proven resilient and remained in contraction territory throughout 2019, saw data negatively impacted by the broader environment in the fourth quarter, leading the Bank of France to lower its 2020 growth forecast to just 1.1%. Though French manufacturing activity remains in expansion territory, October's composite PMI survey reflected declines in expectations for new factory orders, as well as a contraction in hiring for manufacturing sector jobs for the first time in two years. While October's services PMI came in at 55.0, in-line with expectations, economists in France forecast softness in manufacturing to begin to impact recent vigor in the services sector in the coming months. It still remains to be seen whether economic forecasts in the region will be adjusted upward as the impact from the U.S. and China's abbreviated trade agreement in December is realized. That the Ifo Institute's survey of German business expectations for December notched a surprise increase for the fourth straight month is evidence that while the country's manufacturing slump is all but over, some manufacturers see brighter days ahead.

### Portfolio Management Team


**Andrew Manton**
Portfolio Manager

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.

**Jonathan Katzman**
Research Analyst

Jonathan Katzman is a Research Analyst for the Shelton International Select Equity Fund. Prior to joining Shelton Capital, Mr. Katzman worked as an analyst at PNC Bank's Asset Management Group and held positions in Hong Kong with Morgan Stanley and Tree Line Investment Management. He received a B.A. with Honors from Dartmouth College.

**Abheek Bhattachayra**
Research Analyst

Abheek Bhattachayra is a Research Analyst for the Shelton International Select Equity Fund. Prior to joining Shelton Capital, Mr. Bhattachayra worked as a research analyst for Firefly Value Partners and Davis Selected Advisers and was previously a journalist for the Wall Street Journal's Hong Kong bureau. He earned an MBA from Columbia Business School and a B.A. with Distinction from Yale University.


Though outgoing European Central Bank ("ECB") president Mario Draghi echoed a message of weaker growth momentum and underwhelming inflation during his final meeting in October, his replacement, former International Monetary Fund ("IMF") managing director Christine Lagarde, seems to have added differing perspective to the bank. After confirming the ECB's stance that rates will stay at current levels or lower until the bank notices evidence of inflation, Lagarde expressed that risks to the Eurozone's muted growth outlook had become less severe. She also confirmed the ECB had begun asset purchases of $22.3 billion per month to accommodate the bank's current policy stance, a program that will persist as needed. Ms. Lagarde is currently conducting a wide-ranging ECB policy review scheduled to be completed by the end of 2020.

In the UK, Prime Minister Boris Johnson finds himself in prime position to deliver Brexit after his Conservatives won a December 12 general election in landslide fashion. The Conservatives now hold an eighty seat majority in Parliament after the Labour Party's worst showing in a general election since 1935. The result came after more than two months of negotiations between Johnson and EU leadership concerning the terms of a new withdrawal bill by which the UK would leave the EU prior to the October 31 deadline. After the bill was handily defeated in Parliament on October 19, Johnson was left with no choice but to request yet another extension from the EU and give in to Labour Party demands calling for a snap election. As a result, EU Council president Donald Tusk granted a three-month extension for the UK to pass a bill in Parliament, and a general election was set for December 12. With consensus now expecting the UK to leave the EU with a deal, Governor of the Bank of England, Mark Carney, has stressed that Britain's financial system is well prepared for a smooth transition, and would even be able to withstand the shock of a 'no-deal Brexit.' Economists in the region also expect incremental increases in post-election economic momentum that had previously been stymied by lack of clarity surrounding Brexit. That being said, the risk of a 'no-deal' Brexit has not been eliminated, since the actual trading agreement has not been finalized yet. The UK will enter a transition

period following the official withdrawal from the EU until December 31st, 2020 – a hard deadline imposed by Mr. Johnson. If an agreement on trading terms is not agreed upon, UK goods sent to the EU may be subject to tariffs.

Trade negotiations between the U.S. and China continued to dominate headlines throughout the quarter, culminating in the confirmation of a breakthrough 'Phase 1' agreement between the two sides. Dialogue between trade representatives of the two countries at the beginning of the quarter, however, suggested that any progress on trade would be difficult to achieve. In early October, the Trump administration blacklisted twenty-eight Chinese companies for their involvement in the surveillance, detention and alleged ethnic cleansing of Muslim Uyghurs in Xinjiang Province, and placed travel bans on Chinese officials linked to such activity. Though the decision prompted critical messages from Beijing that also conveyed limited expectations for a trade deal, negotiations came back on track when Vice Premier Liu He arrived in Washington during the second week of October to meet with President Trump. The meetings ended with President Trump announcing that he was working with the Chinese on a 'Phase 1' deal covering agricultural purchases, financial services and intellectual property that would be signed by both himself and President Xi Jinping at the APEC summit in Chile five weeks later. The U.S. also agreed to halt a planned tariff increase from 20% to 30% on $250 billion worth of Chinese imports previously scheduled for late October. Despite intermittent obstacles to further progress including President Trump threatening additional tariffs in the absence of a 'Phase 1' deal and dismissing the need for a deadline, U.S. Congress passing legislation aimed at protecting human rights in Hong Kong and Chinese media reports that Beijing was planning to publish a list of unreliable entities that could lead to sanctions on American companies, reports surfaced on December 12 that the U.S. and China had in fact reached a 'Phase 1' deal, just three days before additional U.S. tariffs on Chinese goods were to go into effect. President Trump and Chinese authorities confirmed the agreement, and President Trump cancelled all tariffs due to go into effect on December 15. The agreement is said to consist of articles governing intellectual property rights, technology transfer, Chinese commitments to purchase $40 billion in agricultural goods, and a schedule to govern the gradual phasing out of existing duties. As of December 31st, the Chinese government has remained very tight-lipped about the details of the agreement and have not committed to a signing date.

Chinese economic data released during the fourth quarter showed signs of resilience after much of the summer's data provided evidence of a country struggling to keep pace with robust growth targets. Third quarter GDP growth slowed to 6.0% YoY, the weakest quarterly growth number in twenty-seven years, and October's Official Manufacturing PMI came in below expectations at 49.3 versus 49.8 the previous month, as export orders declined to their lowest level since July. Furthermore, the country's official non-manufacturing PMI hit its lowest level since 2015. Economic activity in November, released just days after Liu He's visit to the U.S., was more positive as industrial output for the month posted a 6.2% YoY increase and retail sales climbed 8% YoY versus expectations for 7.6% YoY rise. While fixed asset investment remained unchanged at 5.2% for the January-October timeframe as Beijing continues to crack down on property investment and speculation, the Chinese economy is expected to continue to show signs of a revival over the coming months as positive effects from the trade deal with the U.S. take hold.

Still, short-to-medium term economic momentum will do little to ease financial pressure at numerous poorly-run Chinese industrial companies facing declining profitability and overcapacity. Among the most notable red flags to emerge was a sharp increase in onshore defaults amongst private Chinese firms participating in the mainland's $4.4 trillion corporate bond market. Though the default rate for state-owned enterprises remains under 1%, that for private companies has reached 4.9%, up from just 0.6% in 2014. This development could have severe consequences for a Chinese economy already facing an uphill battle, particularly if default risks spill over to China's largest financial institutions. Loan growth in previous years allowed China's total debt-to-GDP to rise from 120% in 2007 to over 300% in 2019. The government may look to stimulate more loan growth in 2020 to support the cooling economy but the combination of rising loan defaults and declining efficacy of new loans, will be a challenge for years to come. The country's Incremental Capital Output Ration (ICOR), or amount of money needed to produce one extra unit of GDP growth, went from an already high level of $3 in 2007 to over $9 in 2018, while the GDP growth fell by half. This is reflective of the previous stimulus going into less productive real estate causing housing price bubbles in cities all over the country.

Numerous headlines unrelated to trade negotiations also emerged from Greater China during the fourth quarter. In Hong Kong, the pro-democracy protests raged on and continued to hamper the local economy, which is now expected to contract 1.3% for 2019. While Hong Kong is expected to return to growth in 2020, a 43% decline in visitor arrivals in October has taken its toll on the local retail market as overall unemployment rose to 3.2% at the end of November and business confidence dropped to its lowest reading since April 2003. Some in Hong Kong are convinced the worst of the anti-Beijing protests are over, particularly as a record voter turnout helped pro-democracy candidates gain control of seventeen of the eighteen District Councils in November's local election. Chief Executive Carrie Lam seems to enjoy the firm backing of Beijing and continues to refuse protesters' key demands, however, which could mean that unrest should persist and receive support from voices overseas. Beijing has been quick to not only confront critics, but also threaten retaliation against any country or company that speaks out against what China believes to be their national development interests. In October, China threatened to cancel the broadcasting of NBA games in the country if they did not fire an official who tweeted support for Hong Kong protestors. These intimidation tactics are also being used against countries that are considering banning the use of Huawei equipment in their 5G buildouts including Germany, Canada, and the UK. In Germany, for example, the Chinese ambassador directly threatened Germany's access to the Chinese auto market if they chose to exclude Huawei from the German telecom market.

In Emerging Markets, Indonesia's Bank Sentral held its key seven-day reverse repo rate steady at 5.0% at its November meeting; the first pause after four straight cuts. The bank still decided to cut the reserve requirement ratio for banks by 50bps, freeing up $1.84 billion to stimulate lending in an economy that saw growth decline to 5.02% in the third quarter, the slowest since the second quarter of 2017. The Bank of Thailand echoed Indonesia's decision to hold its benchmark interest rate, which stands at an all-time low of 1.25%. Additionally, the central bank lowered its 2019 and 2020 growth and inflation forecasts, citing external trade headwinds and political uncertainty. With Thai exporters and the tourism industry, both key components of GDP, struggling due to the strengthening Baht, Thai policymakers have vowed to take measures to limit short-term capital inflows and ease restrictions on moving money abroad. Should trade frictions and slowing global growth accelerate, Thailand's healthy current account surplus are due to continue to draw inflows into the Baht, creating a conundrum for the central bank.

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## Portfolio Review

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The top five contributors in the fourth quarter were ASML Holdings (Expansion), CRH Plc (Expansion), Techtronic Industries (Expansion), BNP Paribas (Maturity) and KBC Group (Maturity). The top five detractors were Nokia Oyj (Maturity), Bangkok Bank (Expansion), Thales (Deceleration), Safran (Deceleration) and Unilever (Deceleration).

Regionally, the top contributors in the quarter were Japan and Latin America, while Europe and Asia ex-Japan detracted most. Energy, materials, and financials were the top contributors by sector, while IT, industrials, and healthcare detracted most.

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*For a complete list of portfolio strategy investments and their respective contribution for the preceeding 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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