Shelton Tactical Credit Fund

Quarterly
Commentary
As of June 30, 2024

Market Commentary

In retrospect, the second quarter of 2024 felt a bit like a round trip. Coming off a string of reaccelerating inflation and growth reports in Q1, rates continued to push higher through April, before a run of more welcoming data began to turn the tide and carry rates back to relatively unchanged levels.

First quarter GDP decelerated from the roaring 4.9% in Q3, to a still heady 3.4% in Q4, to a more modest 1.4% in Q1. As of July 1st, Q2 is currently tracking to a 1.73% figure according to the Atlanta Fed GDPNow Forecast. It appears that the cumulative effect of interest rate increases is starting to have its intended effect. Compounding this apparent slowdown is the dwindling impact of all the fiscal stimulus over the last few years, leaving consumers less flush.

The Fed left rates unchanged at both the May and June meetings, while communicating that rate cuts may be appropriate at some point later in the year, but only when there is sufficient confidence that inflation is on a sustainable path back to 2%.

At quarter end, markets are pricing in slightly less than two cuts in 2024, while the FOMC dot plots indicate one. This is yet another reversal, where the market is anticipating more cuts than Fed projections. Whether the first cut comes in September, November or December will impact the front end of the yield curve, although it shouldn't create massive volatility in the intermediate and longer portions of the yield curve. In last quarter's commentary, we opined that the Fed should wait longer before starting to cut rates, as their behavior had driven the dramatic loosening of financial conditions. When combined with the rise in energy and other commodity prices, and the multitude of kinks in global supply chains (Red Sea, Panama Canal, Port of Baltimore, etc.), this was creating risks that inflation could stubbornly refuse to decline, if not start to reaccelerate. This patience has been prescient, as inflation readings have begun to moderate, and many segments of the economy have begun to slow. The labor market is still quite healthy and essentially at full employment, but there are cracks forming around the edges. As Chairman Powell has observed at recent press conferences, the risks on both sides of their dual mandate of price stability versus employment have come back into better balance. This will allow the Fed to remain data dependent and begin cutting rates sometime later this year in their quest to orchestrate a soft landing.

In Q2 2024, the Fund generated returns of +1.27% (DEBIX) and +1.16% (DEBTX). Below is a table of returns for the Fund, various relevant indices, and the Non-traditional Bond category. Performance in the quarter was strong across the board, exceeding all relevant indices and the Morningstar Non-traditional Bond Category as well. Even more notable is the fact that the Fund achieved these results despite being higher in average credit quality than the HY index, and longer in duration than the Non-traditional bond category. We attribute this to our credit selection and ability to find unique uncorrelated investments, our interest rate hedges, and our dynamic and tactical adjustments to the portfolio as macroeconomic and single-name data evolves. Our longer-term performance remains very strong and is a testament to our ability to overcome the vagaries of the rates markets by stringing together significantly more idiosyncratic winners than losers over time. In December 2023, the fund reached its 10-year anniversary, and the fund has outperformed its benchmark (Bloomberg US Aggregate Index) by over 145 basis points annually over the last 10 years ending June 30, 2024.

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Portfolio Management

Peter Higgins
Head of Fixed Income & Sr. Portfolio Manager

Peter Higgins has over 25 years of experience in fixed income investing, most notably as Partner and Lead Portfolio Manager at both Ares Management and BlueBay Asset Management. Previously, Peter specialized in global leveraged finance at investment banks such as Deutsche Bank AG, Goldman Sachs & Co. and Credit Suisse in both London, England, and New York City. Peter earned a bachelor's degree in Economics-Political Science from Columbia University.

Jeffrey Rosenkranz
Portfolio Manager

Jeffrey Rosenkranz has 25 years of experience investing in the credit markets, with an emphasis in high yield, distressed debt, and special situations and has worked at firms including Cedar Ridge Partners, LLC, Durham Asset Management, Cooperstown Capital Management and Ernst & Young LLP. He holds an MBA from the Stern School of Business at New York University and a B.A. from Duke University. He is also a Certified Public Accountant.

William Mock
Portfolio Manager

William Mock has 25 years of experience as a trader and portfolio manager of fixed income and derivatives portfolios, working at Citibank, Societe Generale, and TKI Capital prior to joining Shelton Capital in 2010. He is also lead portfolio manager of Shelton Capital's other municipal and government bond mutual funds. William holds a B.S. in Electrical Engineering from Kansas State University and an MBA from University of Chicago Booth School of Business.

Chris Walsh
Portfolio Analyst

Chris Walsh has over nine years of experience analyzing credit and equity markets. He has been with Shelton Capital since November 2016. Chris earned a B.A. in Economics, Villanova University.

	2Q24	YTD	1YR	3YR	5YR	10YR
Shelton Tactical Credit Fund (DEBIX)	1.27%	3.27%	7.67%	0.37%	2.71%	2.81%
Bloomberg U.S. Aggregate Bond Index	0.07%	-0.71%	2.63%	-3.02%	-0.23%	1.35%
Bloomberg U.S. Investment Grade Corporate Bond Index	-0.09%	-0.49%	4.63%	-3.03%	0.62%	2.34%
Bloomberg U.S. High Yield Corporate Bond Index	1.09%	2.58%	10.44%	1.65%	3.91%	4.31%
Bloomberg U.S. Investment Grade Municipal Bond Index	-0.02%	-0.40%	3.21%	-0.88%	1.16%	2.39%
Morningstar Nontraditional Bond Fund Category	0.90%	2.68%	7.04%	0.79%	1.93%	1.88%

Performance figures represent past performance and are not a guarantee of future results. The investment return and the principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost; current performance may be lower or higher than the performance data quoted. For more current month-end Fund performance information, please call our office at (800) 955-9988.

The Fund's Advisor, Shelton Capital Management (the "Advisor"), has contractually agreed to reimburse expenses incurred by the Fund to the extent that total annual fund operating expenses (excluding acquired fund fees and expenses, certain compliance costs, interest and broker expenses relating to investment strategies (including commissions, mark-ups and mark-downs), leverage interest, other transactional expenses, annual account fees for margin accounts, taxes (such as income and foreign withholding taxes, stamp duty and deferred tax expenses), and extraordinary expenses such as litigation or merger and reorganization expenses, for example) exceed 0.98% and 1.23%, for the Institutional and Investor class shares, respectively, until May 1, 2025.

Fund Expenses - DEBIX (gross): 1.62% | DEBIX (net): 0.99%
DEBTX (gross): 1.87% | DEBTX (net): 1.24%

Portfolio weightings were higher in corporate bonds and lower in municipal bonds. We also did not have any cash credit short positions in acknowledgement of the significantly higher cost of carry and the need to carry positions longer given expectations for the delayed onset of a recession. Although we appreciate the all-in high yields for corporate bonds, spreads are tight, so we have instituted a portfolio hedge by being short risk on the IG CDX index.

Corporate bond long positions were a strong contributor to performance overall, on account of strong credit analysis in selected lower rated credits, and event-driven gains in a few of our positions. Favorable credit selection also allowed us to avoid any major downside surprises. Longer duration, higher quality rate sensitive positions were a very minor drag on overall performance, but the attractive yield on these quality IG borrowers should prove out over the course of the year as rates stabilize or even head lower. We continued to strike a good balance between prudent credit selection in single B and select CCC credits we believe are underappreciated by the market and rating agencies, while avoiding weaker single Bs and CCCs which could be severely punished in a downturn.

The borrowers in our portfolio reported solid Q1 earnings generally across the board and offered favorable yet prudent 2024 guidance as well, reinforcing our decision to upgrade the quality of the portfolio in the face of cost pressures and a potential Fed-induced economic slowdown. We enjoyed some single-name outperformance where better than expected earnings were applauded, credit improvement was recognized by the markets and rating agencies, or corporate transactions were announced. We expect this dispersion, where strong performance is rewarded, and poor performance is penalized, will accelerate going forward. Issuers that materially miss earnings, call off corporate transactions, or otherwise disappoint their investors will be severely punished. This kind of market is highly conducive to our strategy, when markets are generally rangebound or sideways and individual credit selection is rewarded or punished.

The Fund also benefitted from idiosyncratic gains in Triton Water Holdings, which announced a merger with Primo Water triggering a very good outcome for our bonds, and JBS Foods, which launched an above-market tender offer for our position. Interest rate hedges protected the portfolio from large moves in rates but were essentially breakeven overall given the swings in rates over the quarter.

The top 5 contributors and detractors for the quarter are listed below:

Top 5 Contributors	**Top 5 Detractors**
Triton Water Holdings Inc.	The Kraft Heinz Company
Guitar Center Inc.	Visa Inc.
Six Flags Entertainment Corp.	Sirius XM Holdings Inc.
JBS USA Holdings	Tobacco Settlement Finance Authority WV
Warner Music Group Corp.	Roche Holdings Inc.

Corporate Commentary

High yield corporate bonds began the second quarter with a rocky start, as rates rose rapidly to start the quarter, with the 10-year Treasury climbing from 4.20% on March 28th to 4.70% on April 25th. This led to the worst month of performance for HY bonds since October, but quickly reversed after Chair Powell struck a more dovish tone at the FOMC's May meeting, indicating that the Fed was done hiking for the year and could potentially cut. The HY market responded by welcoming a deluge of new supply and refinancing, some on the riskier end of the spectrum, digesting it well, with spreads holding relatively steady in May. As summer set in, market volatility cooled some in June and HY delivered modest coupon-clipping returns.[1]

BB's were the strongest performing cohort at +1.32%, followed by single B's at +1.03%, and CCC's at -0.01%. This was a reversal of the first quarter, as CCC's struggled due to some stress in a couple large issuers and perhaps investors pricing in the potential for stress on the horizon on some softening data. We had indicated in our first quarter commentary that we believed this would take place, and while we have not seen an overall crack in CCC's, we are diligently watching for signs of further weakness. [1]

In investment grade, yield won out, with BBB's returning +0.08%, followed by single A's -0.15%, AA's -0.64%, and AAA's -1.35%. Investment grade funds had an overall quarterly outflow of -$1.8 billion, while high yield saw an inflow of $4.7 billion. Investment grade new issuance was above pace with this quarter last year, with supply totaling +$368 billion, versus +$339 billion last year. High Yield new issuance was $93 billion in Q2 versus $60 billion in Q2 2023. The pace of CCC issuance cooled from Q1, while single B issuance remained strong and continued to outpace last year. Refinancing or repayment of debt continued to be the most common use of proceeds, accounting for 71% of YTD issuance, a trend we expect to continue as issuers peck away the much publicized "wall of maturities."[1,2]

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Corporate Commentary (continued)

The balance sheets of HY issuers continue to appear in good shape, although are seeing some modest erosion. Leverage ticked up following two consecutive quarters of declines, to 3.98x. Leverage is now 0.22x higher than 1Q23's record low, although still well below the long-term average of 4.31x. It is also notable that spread per turn of leverage is at a nine-quarter low at 86bp, significantly below the historical average of 131bp. Leverage for BB, B, and CCCs is 3.3x, 4.5x, and 6.8x versus the past decades' average of 3.5x, 5.0x, and 7.6x, respectively. Interest coverage ratios decreased -0.11x to 4.89x and are still above the historical average of 4.48x. [3]

The HY default rate ticked up slightly by 23bp to 1.79%, which is down 109bp since year end. For context, the 25-year HY default rate is 3.4%. Notably, leveraged loans are seeing a significantly higher default rate, at 3.10%. This spread of 131bp over HY is the highest in a decade as the effects of higher-for-longer policies set in. HY spreads widened slightly in the quarter from +298bp to +309bp, and still remain relatively tight especially for a pre recessionary period. Investors continue to be drawn to the significant all-in yields offered. [3]

Municipal Commentary

For the full quarter the Bloomberg Municipal Bond Index (-0.02%) beat the Bloomberg US Treasury Index (-0.86%). Treasury yields continued their ascent from Q1 through April, then reversed course and fell in May and June as the market became convinced that the Fed would begin cutting rates in 2024. The muni market yields moved higher with US Treasuries in April, then in May as Treasury yield began dropping muni yields continued higher, pressured by large new issuance calendars nearly every week. June saw the muni market resume moving lower alongside US Treasuries. The table below shows the change in AAA municipal yields in basis points across the curve during the quarter. [1]

Maturity	April	May	June	Full Quarter
2 Years	28	8	-22	15
5 Years	29	33	-18	43
10 Years	28	31	-24	35
30 Years	29	-2	-21	6

AAA Muni/US Treasury ratios rose across most of the curve during the quarter as mentioned above on supply side market technicals, as the weekly new issuance regularly exceeded $10 billion in the quarter. The AAA Muni/US Treasury ratio rose 1%, 8%, 5%, and fell 3% at 2, 5, 10, and 30 years respectively, to end the quarter at 66%, 68%, 65%, and 83%. Though the ratios have risen, the municipal bond market remains rich and it's widely anticipated that ratios will remain under pressure to move higher as issuance in the late Summer and early Fall is expected to be inflated with issuers going to market in advance of expected election related volatility in Q4. [1]

Outlook

There are cracks forming in the labor market. April job openings in the JOLTS survey fell to a revised 7.9 million, a three-year low and down more than a third from the peak of 12.2 million in 2022. There are now just 1.2 postings for each person seeking work, back to pre-pandemic levels, and the 2.2% quits rate has also normalized to pre-Covid levels as well. May JOLTS data took a small step backwards, with 8.1 million openings, but the general trend is still intact. The unemployment rate rose to 4% in May, up from a low of 3.4% last year. Generally, when unemployment rises this much in a short period of time it does not stop here, but instead continues to head higher.

Another indication of slowing economic activity is the Citi US Economic Surprise index, which just reached 22-month lows. The Atlanta Fed GDPNow Forecast for Q2 currently sits at 1.7%, which would mark a second consecutive quarter of below-trend growth. We expect GDP to continue to decelerate in 2024, hindered by the continued lagged impact of higher rates, withering contribution from fiscal stimulus, and rising consumer debt balances.

The philosophical debates around term premium required to hold longer dated bonds and the real-world impact of rising supply of treasury bond issuance will determine the shape of the yield curve and performance for intermediate and longer dated fixed income. Of course, microeconomic fundamentals and corporate earnings will be the key to changes in credit spreads, but supply and demand technicals will also factor into corporate bond performance, especially as a rotation into high quality bonds is possible due to the pension funding status for the largest 100 corporates plans reaching 103.4% We believe that real interest rates are unnecessarily high and will come down as the economy slows, offsetting concerns about a rising supply of treasuries. Furthermore, since we do not expect corporate earnings to reach their CY '24 estimates amidst a slowing economy, equities seem vulnerable and the appeal of bonds as a safer fixed income return should counterbalance the mania for term premium.

Following the first debate, there has been an acceleration in the markets' pricing-in of a Republican victory. This is putting pressure on longer-term rates, with the 'steepener' trade being a way to express this view. We believe that it is too early to extrapolate any election outcome into market repercussions. Potential policies that are espoused on the campaign trail or at a debate are often just that – talking points that never come to fruition, either because the candidate moves into governing mode and tacks more centrally, or because they would require approval from Congress, which has proven to be an impossible task for years. For these reasons, while we will be cognizant of potential impacts on the long end of the curve, nearer-term economic fundamentals will be the more significant driver of interest rates, especially 10 years and in.

The FOMC is in data-dependency mode, not wanting to wait too long to start rate cuts and tip the economy into an unnecessary recession, while also being terrified of allowing inflation to re-accelerate. As we have written countless times, because the Fed is more comfortable running the playbook of re-stimulating an economy out of a recession rather than trying to re-conquer entrenched inflation, they will err on the side of making sure inflation is well on the way to being vanquished before cutting rates. While 25bp isn't material in and of itself, the symbolism around that first cut may likely unleash animal spirits in the equity and bond markets. It also may trigger a wave of fund flows out of short duration fixed income into intermediate and longer duration bonds. This phenomenon is recently getting a lot of media attention as individuals are being warned to avoid the 'cash trap', and we agree that investors should be methodically moving some of their money market and cash holdings into longer duration bonds.

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Outlook (continued)

We know that Fed policy operates with a lag, and because such a small percentage of mortgages, auto loans, and corporate borrowings have re-set at higher rates, the lags, this time around, might be even longer. Consumers have been the engine behind economic growth, but now they are dipping into their savings, as evidenced by the personal savings rate falling below pre-pandemic levels to 3.9%.

Recent corporate commentary generally offered upbeat outlooks for 2024, however those companies focused on serving lower income cohorts are expressing more concern about the demand outlook given the disproportionate burden that inflation and higher rates have on these types of consumers. The ideal scenario is above trend growth without inflation, a very challenging proposition. Perhaps significant increases in productivity coupled with increased immigration will keep the labor market in check. However, given the lags in monetary policy, the Fed has an unenviable task of predicting if this is possible. Until we have more confidence as to which way we are headed, rates are likely to remain rangebound with bouts of volatility and a trendline slowly moving lower. If the economy can sustain non-inflationary growth, rates will stay somewhat elevated and risk assets should perform well. However, if the economy slows due to the lagged effect of higher rates, or the Fed has to tap the brakes to achieve this objective, then equities and lower-quality fixed income have more downside. Given where all-in yields are now, we believe they are generally compensating investors for additional spread widening all the way down to the single-B rating tier. Below single-B, you better get your credit analysis and downside protection correct, as the lack of trading liquidity in that tier severely punishes mistakes.

We believe the sweet spots for future total returns are threefold: high quality A, BBB, and BB corporate bonds; certain lower rated single-B and CCC corporate bonds that we believe are stronger and more resilient than the market and have an identifiable path to credit improvement; and some event-driven investments where the still-wide-open credit markets are available to facilitate the transactions to drive these catalysts. Mathematically, even if spreads widen a few hundred basis points further, BBs at yields of 6.58% would still produce a breakeven return over the next 12 months. If rates go lower and/or the recession proves to be milder, then total returns could easily eclipse 10% over that period. In this latter scenario, we would make the tactical adjustment to add more credit risk to the portfolio. There are valid reasons to believe spread widening might stop short of previous recessions, as the index has a better-quality composition (more BBs, fewer CCCs), beginning all-in yields are higher than the onset of a typical recession, and the average dollar price of bonds is much lower and much closer to recovery rates. However, if spreads were to blow out to levels above +800 basis points that are often reached in severe recessions, total returns would likely be negative. Navigating these bouts of volatility by adjusting credit quality overall and selecting the right individual securities will be the keys to success, and we are confident in our ability to thrive in such an environment.

As always, we will be cognizant of valuations, while continuing to seek value and compelling risk/reward investments across fixed income products with a focus on the corporate and municipal bond markets.

Sources: 1 Bloomberg, 2 CreditSights, 3 JP Morgan Data

IMPORTANT INFORMATION

Investors should consider a fund's investment objectives, risks, charges and expenses carefully before investing. The prospectus contains this and other information about a fund. To obtain a prospectus, visit www.sheltoncap.com or call (800) 955-9988. A prospectus should be read carefully before investing.

Credit-related instruments typically decrease in value when interest rates increase. Concentration in a small number of issuers increases the risk that one issuer could have a large adverse impact on the Fund's return. Borrowing and frequent trading could increase the Fund's operating expenses. High-yield bonds involve greater risk of default, and may be more volatile and less liquid, than investment grade securities. Subordinated and unsecured loans may be disproportionately affected by default and downgrade. Foreign investments may be adversely affected by currency fluctuations, lower liquidity, tax regulation, and political instability. Derivatives can be highly illiquid and difficult to unwind. The Fund's short positions may equal up to 100% of the Fund's net asset value. Short sales theoretically involve unlimited loss potential since the market price of securities sold short may continuously increase. The Bloomberg Barclay U.S. Aggregate Bond Index is an unmanaged index of the U.S. dollar-denominated investment grade fixed-rate taxable bond market. It includes government, corporate, mortgage-backed, and asset-backed debt securities with a maturity of at least 1 year. It is not possible to directly invest in an index.

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