SHELTON CAPITAL MANAGEMENT

Shelton Tactical Credit Fund

Quarterly
Commentary
As of September 30, 2024

Market Commentary

The waiting is the hardest part…but sometimes the anticipation is better than the reality.

Interest rates moved steadily lower during Q3 as economic data confirmed cooling inflation and supported a Fed pivot. This change of direction by the FOMC was from a path singularly focused on conquering inflation, to another where the balance of risks had shifted towards rising unemployment. Therefore, Jerome Powell and his fellow governors felt more and more comfortable signaling that their first interest rate cut would come in September. Fund flows into fixed income products accelerated, driving spread tightening and solid total returns. As labor market indicators weakened further, the questions evolved from 'When would the first cut begin?' into 'How large a cut was warranted?' and 'How fast and deep would the rate cut cycle be?' It wasn't until a well-timed WSJ article during the pre-meeting quiet period that a half-point cut was indeed in play for September. The dot plots updated during the September Fed meeting showed a soft landing in the median forecasts.

GDP rebounded from 1.4% in Q1 to 3.0% in Q2. As of October 1st, Q3 is currently tracking to a 2.5% 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 of orchestrating a soft landing. Compounding this apparent slowdown is the dwindling impact of the fiscal stimulus over the last few years, leaving consumers less flush; however, they're still spending what remains.

The Fed left rates unchanged in July and then cut 50 basis points in September. At quarter end, markets are pricing in close to three more cuts in 2024 and another four to five cuts in 2025. Now that we are past the first cut, the speed and depth of the rate cut cycle will have an outsized impact on the belly of the UST curve. The long end of the curve will also be impacted by philosophical issues like R* and the terminal rate, and by expectations around fiscal policy, deficit spending and budgetary restraint (or lack thereof).

Although the balance of risks has likely shifted back into equilibrium between inflation and full employment after September's employment report, the FOMC still has a very difficult task ensuring inflation does not reappear or reaccelerate, while also protecting the labor market from further deterioration. Fed governors have spoken about how they do not want any further weakening of the labor markets from here. All these things operate with a lag, so if all the cumulative tightening over the last several years is still impacting hiring and firing decisions, we won't know until later that the employment picture was still deteriorating. In addition, we now have the added uncertainties of escalating conflict in the Middle East, and the upcoming Presidential and Congressional elections. The multiple-choice question everyone is asking seems to be 'Will we have a soft landing, hard landing, or no landing at all?'

In Q3 2024, the Fund generated returns of +4.12% (DEBIX) and +4.11% (DEBTX). Below is a table of returns for the Fund, various relevant indices, and the Morningstar Non-traditional Bond category. While performance in the quarter was strong and the Fund comfortably outperformed the Nontraditional Bond category, the Fund did trail the relevant investment grade-rated indices on account of shorter duration, or in the case of the HY index, lower CCC exposure. However, year to date performance significantly exceeds the Nontraditional bond category and all indices, except for a small lag versus the high yield index. Our crossover-rated positioning has been purposeful and diligent, which has allowed us to navigate the uncertainties of the rate cut cycle. 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 and the occasional idiosyncratic hiccups by stringing together significantly more idiosyncratic winners than losers over time. In December 2023, the fund reached its 10-year anniversary, and the performance of the Fund since inception stands very tall relative to peers, relevant indices, and the Non-traditional bond category.

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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.

	3Q24	YTD	1YR	3YR	5YR	10YR
Shelton Tactical Credit Fund (DEBIX)	4.12%	7.52%	14.11%	1.51%	3.59%	3.14%
Bloomberg U.S. Aggregate Bond Index	5.20%	4.45%	11.57%	-1.39%	0.33%	1.84%
Bloomberg U.S. Investment Grade Corporate Bond Index	5.84%	5.32%	14.28%	-1.18%	1.16%	2.92%
Bloomberg U.S. High Yield Corporate Bond Index	5.28%	8.00%	15.74%	3.10%	4.71%	5.04%
Bloomberg U.S. Investment Grade Municipal Bond Index	2.71%	2.30%	10.37%	0.09%	1.38%	2.51%
Morningstar Nontraditional Bond Fund Category	3.01%	5.79%	10.11%	1.82%	2.44%	2.22%

Sources: Bloomberg; Morningstar Direct

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 and uncertainties abound, so we increased our portfolio hedge on the IG CDX index during the quarter.

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 significant contributors as rates declined. 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 Q2 earnings generally across the board and offered favorable yet prudent 2H 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 benefitted from idiosyncratic gains in i) Hawaiian Airlines, which received Department of Justice and Department of Transportation approval for their acquisition by Alaska Airlines; ii) Six Flags, which completed its merger with Cedar Fair; iii) SiriusXM, which completed its merger with the Liberty Media tracking stock; and iv) "rising stars" such as Macquarie Airfinance and Warner Music, whose ratings were upgraded to investment grade.

The top 5 contributors and the only 2 detractors for the quarter (6/28/24 - 9/30/24) are listed below:

Top Contributors	**Top Detractors**
The Kraft Heinz Company	Pyxus International, Inc.
Visa Inc.	Guitar Center, Inc.
Roche Holdings Inc.	
Sirius XM Holdings Inc.	
JBS USA Food Co	

Corporate Commentary

The old adage of "sell in May and go away" proved poor advice this past summer as corporate bonds rallied strongly in response to a softening inflation picture. The 10-year treasury yield declined from 4.40% on June 28th all the way to 3.78% on September 30th.[1] As more economic data points came to light, and the Fed began to feel confident in inflation's downward trajectory, officials shifted the conversation more towards ensuring the economy was on strong enough legs to support a robust employment picture. This set up a Goldilocks scenario for corporate bonds across the board, with the longer-duration highly rated component delivering strong returns arm-in-arm with lower quality issuers driven by a more favorable dot plot. In September, both HY and IG markets digested a large issuance calendar with ease.

In investment grade, duration prevailed, with AAA's returning 6.93%, AA's 6.06%, single A's 5.86%, and BBB's 5.76%. Investment grade funds had an overall quarterly inflow of $60.6 billion, and high yield funds had an inflow of $16.5 billion. New issuance for investment grade was a massive $441 billion, eclipsing the $300 billion this quarter last year. High yield new issuance was also very strong with companies bringing $89 billion in new supply as compared to $48 billion in 3Q23. The market was open to all issuers, with CCC's bringing ~$5 billion in new issuance, versus less than a billion this quarter last year. Consumer-sector HY companies in particular placed ~$11 billion in September alone. 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 at the much publicized "wall of maturities."[1, 2]

1 Bloomberg
2 CreditSights

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Corporate Commentary (continued)

The balance sheets of HY issuers continue to appear in good shape, amid some downward guidance revisions. Leverage remained flat at around 3.98x. Leverage is 0.22x higher than 1Q23's record low, although still well below the long-term average of 4.31x, and well below the peak in 1Q21 at 5.92x. Spread per turn of leverage ticked up slightly to 88bps from 86bps, still significantly below the historical average of 131bp. Leverage for BB, B, and CCCs is 3.3x, 4.7x, and 6.8x versus the past decades' average of 3.5x, 5.0x, and 7.6x, respectively. Interest coverage ratios remained stable at 4.89x and are still above the historical average of 4.50x.[1, 2]

The HY default rate ticked down slightly by 10bp to 1.64%, which is down 124bp since year end. This represents the lowest default rate in nearly two years, and for context, the 25-year HY default rate is 3.4%. Notably, leveraged loans are seeing a significantly higher default rate, at 3.70%, which is above their long-term average of 3.0%. This spread of 206bp over HY is the highest since 2000 as the effects of higher-for-longer policies sink in. HY spreads widened slightly in the quarter from +337bp to +345bp, and still remain relatively tight especially if a recession still materializes. As yields creep down to 7% in HY, the all-in yield picture is still meaningful although less generous than the 8-9% earlier in the year.[1, 2]

Municipal Commentary

Though they all had positive returns, the Bloomberg US Treasury Index (4.74%) outperformed both the Bloomberg Municipal Bond Index (2.71%) and Bloomberg Muni High Yield Index (3.21%) in the 3rd quarter. Treasury yields continued the trend to lower rates that began in May, with the entire Treasury curve moving lower as the markets anticipated the Federal Reserve's first interest rate cut. Municipal market yields were highly correlated with US Treasuries over the course of the quarter. The table below shows the change in AAA municipal yields in basis points across the curve during the quarter.[1]

Maturity	July	August	September	Full Quarter
2 Years	-29	-37	-9	-75
5 Years	-19	-29	-10	-59
10 Years	-9	-8	-7	-23
30 Years	-9	-5	-10	-24

Source: Bloomberg

AAA Muni/US Treasury yield ratios were stable on the short end while rising on the long end. The AAA Muni/US Treasury ratio was flat at 2 years, fell 1% at 5 years, rose 5% at 10 years and 3% at 30 years, to end the quarter at 66%, 67%, 70%, and 86%. Though long-end ratios have risen, the entire municipal bond market remains rich to historical averages. Q3 Issuance ($121 billion) has increased as issuers sought to borrow in advance of expected election related volatility in Q4, but this supply has been digested with support from reinvestment money and strong positive investor flows every week of the quarter ($16.8 billion total). A slowing economy usually brings strong inflows as investors seek the relative safety of municipal bonds; those flows may be needed to offset falling reinvestment dollars in Q4.[1, 2, 3]

Outlook

We thought that there were cracks forming in the labor market. The unemployment rate rose from 3.4% to 4.3%. 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 were just 1.1 postings for each person seeking work, back to pre-pandemic levels, and the 2.2% quits rate had also normalized to pre-Covid levels as well. Then we got the September payrolls report, which is causing a rethink on what we thought we knew. With a 72,000 higher revision on top of a 254,000 payroll gain, perhaps the labor market wasn't really slowing after all. Or maybe the building expectations of rate cuts in August and September begat renewed confidence in employers to retain workers or add new ones. The August JOLTS data took a small step backwards, with 8 million openings, up from 7.7 million in July, but the general trend is still intact. The unemployment rate declined to 4.1% in September, down from 4.3% in July and 4.2% in August, yet still up from the low of 3.4% last year.

Perhaps the Citi Economic Surprise index, which bottomed in August and has shot straight up ever since, was showing us the way. The Atlanta Fed GDPNow Index sits at 2.538% as of writing, but the next revision on October 8th is likely to go higher. Gross Domestic Income for 1H 2024 was revised higher recently, from 1.3% to 3.2%, largely on account of faster compensation growth. This would suggest that consumer savings has not dwindled as much as earlier belief. Combined with the wealth effect from equity markets rebounding to all-time highs, consumers should be confident in their ability to keep spending. Yet the quits rate has declined to 1.9%, the lowest since Spring 2020, and other indicators on how individuals are feeling about the job market and their ability to find a new job if fired, or a higher paying job if they switch, are also in conflict with what should be positive consumer sentiment. Psychology suggests that even if consumers have excess savings, growing portfolios, lower inflation, and now lower interest rates, if they have doubts about the labor market, they will be more cautious.

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. Steepness of the curve may also be temporarily influenced by uncertainty as to any policy implications under a new administration; however, nearer-term economic fundamentals will be the more significant driver. 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 102.8% 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.

1 Bloomberg
2 JPMorgan
3 LSEG Lipper

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Outlook (continued)

The FOMC continues to be in data-dependency mode, even though the rate cut cycle has begun. The symbolism around the first cut unleashed animal spirits in the equity and bond markets. It has also triggered a wave of fund flows out of short duration fixed income into intermediate and longer duration bonds. This phenomenon got a lot of media attention as individuals were being warned to avoid the 'cash trap', and we agreed that investors should be methodically moving some of their money market and cash holdings into longer duration bonds. Yet as the recent employment report demonstrates, the future path of the economy and the labor market are unpredictable and therefore lower rates, across the full curve, from here are not a certainty.

Recent corporate commentary generally offered upbeat outlooks for the balance of 2024, however those companies focused on serving lower and even middle-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. Numerous automotive OEMs and parts suppliers have recently cut their outlooks substantially on account of demand weakness and bloated inventories. These companies tend to be bellwethers in terms of their predictive impact on other aspects of the economy.

'Will we have a soft landing, hard landing, or no landing at all?' The Fed's ideal scenario is a soft-landing, one with 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. Further risks from abroad may also impact directionality, including unintended consequences such as the volatility witnessed in early August from the unwind of the Japanese carry trade or the recent Chinese stimulus. Until we have more confidence as to which way we are headed, rates are likely to remain rangebound with bouts of volatility. 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 had 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 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. In light of rate path uncertainty, higher rated investment grade bonds with duration sensitivity are a bit trickier. The recent backup in rates makes them more attractive again, as all-in yields are higher and new issue supply should be a bit more muted. Ordinarily, for a no-landing scenario we would make the tactical adjustment to add more credit risk to the portfolio, but with spreads already very tight and CCCs having rallied 12.54% already this year[1], we'll have to pick our spots rather than indiscriminately buy the entire cohort of lower rated bonds whose dispersion is abnormally high. 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 quite 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.

1 Bloomberg

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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