WASATCH GLOBAL INVESTORS

Quarterly Commentary

Wasatch Emerging Markets Select Strategy

DECEMBER 31, 2019

Trade Optimism Was One Driver of Emerging-Market Performance

OVERVIEW

Accommodative monetary policy and an apparent breakthrough in the trade impasse between the U.S. and China helped push emerging-market equity prices higher during the fourth quarter. The Wasatch Emerging Markets Select strategy posted a solid double-digit gain. The strategy modestly lagged its benchmark, the MSCI Emerging Markets Index, which rose 11.84%. For all of 2019, the strategy's return was significantly higher than the 18.42% return of the Index.

Central banks around the world maintained a general bias toward easing, with the U.S. Federal Reserve cutting its key lending rate for the third time in 2019. The widely expected move dampened enthusiasm for the U.S. dollar, which slipped -3.0% against a basket of major rivals during the fourth quarter. Emerging markets benefited as the falling greenback and lower U.S. interest rates made riskier assets in developing nations more attractive to international investors. A weaker dollar also makes it easier for emerging markets to issue debt denominated in their own currencies.

Brazil was the strategy's greatest source of strength against the benchmark. Stocks rallied in Brazil after the country's Senate gave final approval to landmark pension-reform legislation at the center of President Jair Bolsonaro's plans to cut government debt. The prospect of improving public finances bolstered Brazil's currency—which rose 3.5% against the U.S. dollar during the quarter. A potent combination of falling interest rates, controlled inflation and firming economic data has been a positive driver for Brazilian equities.

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Mexico's central bank cut borrowing costs in December for the fourth time in a row as inflation dipped to 2.63%, below the central bank's target of 3%. The peso finished the quarter 4.7% higher against the greenback, having received an additional boost after the U.S. House of Representatives approved an updated version of the North American Free Trade Agreement. The strategy's holdings in Mexico substantially outgained the Mexican positions in the Index, enhancing strategy performance in absolute terms and relative to the benchmark.

Indian stocks climbed to record highs in the wake of corporate tax cuts, monetary easing and a series of other measures designed to stimulate flagging economic growth. India's gross domestic product (GDP) rose 4.5% in the September quarter from a year ago—down from 5% in the previous quarter and the slowest pace of expansion in more than six years. Weakness in household expenditures—especially in rural areas of the country—impacted our consumer stocks as cautious Indians tightened their belts. India was the strategy's largest source of underperformance relative to the benchmark during the fourth quarter.

The strategy's Korean stocks also underperformed, primarily as a result of company-specific factors. Our significantly below-benchmark weighting in Korea helped to mitigate the adverse effect on strategy performance.

DETAILS OF THE QUARTER

The strongest contributor to strategy performance for the quarter was **Silergy Corp.** Based in Taiwan, Silergy manufactures high-performance mixed-signal and analog integrated circuits used in a wide array of electronic devices. Silergy's stock price had languished during the latter half of 2018 and early 2019 as sluggish demand caused a buildup of inventory in semiconductor supply channels. An uptick in sales during May sparked a turnaround in the stock that accelerated during the fourth quarter. In December, Silergy announced that consolidated revenues for November had risen 38.0% in local currency and 39.7% in U.S. dollars versus November 2018.

A pair of Brazilian holdings—**Weg S.A.** and **Raia Drogasil S.A.**—represented the second- and third-largest contributors, respectively. Weg makes transformers, motors, control panels and other components used to produce and transmit electric power from wind and other sources. With wind energy already the fastest-growing source of power generation in Brazil, we believe Weg is well-positioned to serve the growing demand for wind turbines and other electrical equipment. The company also has been benefiting from a pickup in international markets, particularly China, and from increased demand for its larger, more-profitable electric motors.

Raia Drogasil operates the leading chain of drugstores in Brazil. The company had been struggling as competitors used lower-priced, lower-quality generic medicines to lure consumers. Now that the company has begun offering discounted generics of its own, competitive intensity appears to have eased. The stock rose sharply in October after Raia Drogasil reported quarterly same-store sales growth of 11.9% overall and 7.7% for mature stores versus the same quarter a year ago. The company's retail market share increased 1.7 percentage points nationally and 2.5 percentage points in the key São Paulo market compared to the year-ago period.

The greatest detractor from strategy performance for the quarter was **BGF Retail Co. Ltd**. The company operates convenience stores in Korea. Competitive pressures have hurt BGF's business on both the top and bottom lines. In addition, Korea's populist government has raised the country's minimum wage, swelling BGF's labor costs and squeezing margins further. With convenience-store openings in Korea continuing to outstrip demand growth in the industry, we are reevaluating the strategy's position in the stock.

Medytox, Inc., also a Korean holding, was the second-largest detractor. Medytox manufactures neurotoxins for cosmetic applications. Concerns about the pending approval of the company's products for sale in China continued to weigh on shares of Medytox. Meanwhile, the company's lawsuit against a pair of competitors—which seeks to block U.S. imports of a rival product—have created an additional layer of uncertainty around the stock. On the plus side, a recent inspection of the company's manufacturing facilities by Korea's Ministry of Food and Drug Safety failed to uncover any serious problems, thus removing a potential obstacle to Chinese approval.

The third-largest detractor from performance was **Vitasoy International Holdings Ltd.** A multinational based in Hong Kong, the company offers soy milk, tofu, rice milk, tea, juices and related food-and-beverage products in China and other countries. Investors reacted negatively to Vitasoy's plans to invest more heavily in its soy-milk business to stave off competitive pressures and pave the way for future growth. We think the company's strategy makes sense, however—especially in view of the large untapped potential for packaged soy milk and Vitasoy's strong brand presence in the markets it serves.

OUTLOOK

As was the case during the fourth quarter, a falling U.S. dollar is generally helpful to emerging markets. Weakness in the greenback can become self-reinforcing, as outsized equity gains and stronger economic growth in emerging markets pull investment away from the U.S., further impacting the dollar. Conversely, a strong U.S. dollar can pose headwinds to emerging-market investments. Countries with structurally weak currencies are especially vulnerable to dollar strength, which may compel them to adopt overly restrictive monetary and fiscal policies in order to attract and retain foreign capital.

From the dollar's recent low against a basket of major rivals on January 26, 2018, the greenback rose 11.3% through the end of September 2019. When viewed in that light, the difficulties emerging-market investments faced in 2019 and 2018 seem unsurprising. The MSCI Emerging Markets Index lost -14.58% in 2018—and was up just 5.89% through the end of 2019's third quarter, lagging more-sizable gains in global equity markets as a whole. The dollar's abrupt reversal during the fourth quarter—in which the greenback declined -3.0% against the same basket of competitive currencies—helped propel the MSCI Emerging Markets Index to an 11.84% gain during the final three months of 2019.

Although the dollar's cyclical phases are not actionable for timing purposes, they nevertheless provide us with a rough framework for evaluating the current situation and longer-term probabilities. The dollar's historical tendency to trade within a fairly well-defined band suggests that it cannot continue going up forever. We now seem to be approaching the upper end of that band. If so, the strong-dollar headwind of the past two years may be poised to transform itself into a weak-dollar tailwind for emerging markets.

In the meantime, we think the high-quality companies and innovative disruptors around which we have built the strategy's portfolio are well-positioned to outperform. We look for companies with their own, unique demand drivers that are not tied to macro trends in the global economy. Throughout the dollar's cycles, we believe our fundamental, bottom-up investment approach has the potential to generate attractive returns over time.

Thank you for the opportunity to manage your assets.

Sincerely,

Ajay Krishnan, Roger Edgley, Scott Thomas and Matthew Dreith

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index designed to measure the equity market performance of emerging markets. You cannot invest in this or any index.

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This commentary is intended to provide you with information about factors affecting the performance of the Wasatch Emerging Markets Select strategy during the period. References to individual companies should not be construed as recommendations to buy or sell shares in those companies. Wasatch analysts closely monitor the companies held in the Emerging Markets Select strategy. If a company's underlying fundamentals or valuation measures change, Wasatch will reevaluate its position and may sell part or all of its holdings.

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