WASATCH GLOBAL INVESTORS

Quarterly Commentary

Investor
WHOSX

Wasatch-Hoisington U.S. Treasury Fund

SEPTEMBER 30, 2020

The U.S. and Other Developed Nations Are Caught in a Debt Trap

The views expressed in this commentary are those of Hoisington Investment Management Company (HIMCo), the sub-advisor to the Fund, and may differ from the views of Wasatch Global Investors.

DETAILS OF THE QUARTER

After falling sharply in the first half of 2020, U.S. Treasury bond yields were up a bit in the third quarter. For the three months ended September 30, 2020, the Wasatch-Hoisington U.S. Treasury Fund returned 0.07%, compared to the benchmark Bloomberg Barclays US Aggregate Bond Index return of 0.62%. For the year-to-date through September 30, the Fund gained 24.56%, outperforming the Index, which returned 6.79%. The 30-year Treasury bond yield closed the third quarter at 1.45%, up slightly from 1.41% at the end of the second quarter but down sharply from 2.11% 12 months ago.

ANALYSIS OF ECONOMIC CONDITIONS

An analysis of the shifting dynamic of economic conditions over the past 40 years led us to five conclusions:

FUND MANAGERS

Van R. Hoisington
Lead Portfolio Manager
24 YEARS ON FUND

V.R. Hoisington Jr.
Portfolio Manager
4 YEARS ON FUND

David Hoisington
Portfolio Manager
4 YEARS ON FUND

Data show past performance and is not indicative of future performance. Current performance may be lower or higher than the data quoted. For the most recent month-end performance data, visit wasatchglobal.com. Investment returns and principal value will fluctuate and shares, when redeemed, may be worth more or less than their original cost. The Advisor may absorb certain expenses, leading to higher total shareholder returns. Wasatch Funds will deduct a 2% redemption fee on Fund shares held 60 days or less. Performance data does not reflect this redemption fee or taxes. ***Total Expense Ratio: 0.69%. The Advisor has contractually agreed to limit certain expenses to 0.75% through at least 1/31/2021.***

1) A very powerful secular downdraft has occurred in major measures of economic performance.

2) The U.S. and other developed nations are caught in a debt trap. A term originated by the Bank for International Settlements, it is a condition where too much debt weakens economic growth, which elicits a policy response that creates more debt that results in even more disappointing business conditions.

3) The secular decline in economic conditions and the debt trap preclude the textbook conditions for powerful monetary policy measures to stimulate economic activity. Further, debt financed fiscal programs only boost the economy in the very short run, but ultimately reduce growth.

4) The secular deterioration in economic growth has created a condition of excess resources and disinflation.

5) The workings of the Fisher equation, which have brought Treasury bond yields lower, have been reinforced by a sharp decline in the marginal revenue product of debt.

SECULAR EROSION

Real per capita gross domestic product (GDP), employment, population and productivity have all exhibited pronounced secular deterioration. From 1980 through 2019, real GDP per capita grew 1.7% per annum, sharply lower than 3.1% in the prior 40 years (1940 to 1979).

Real per capita GDP stood at $58,113 in 2019, up from $30,104 40 years earlier. However, if the growth rate in real per capita GDP—the standard of living—had compounded at the 3.1% pace of the prior 40 years, the level would have been $102,087 in 2019, or nearly 75% higher.

Another key macroeconomic indicator, employment growth, also reflects these broader trends. Payroll employment grew by 1.3% per annum in the past four decades, down from 2.8% from 1940 to 1979. Thus, employment growth was reduced by slightly more than half while real per capita GDP was pared by less than one-half. This difference is reflected in productivity change. Productivity growth slowed but held up better than economic output. Nonfarm productivity expanded 1.9% per annum in the past 40 years, down from 2.4% in the prior period.

DEBT TRAP

The concept of the debt trap is consistent with scholarly research, from the 19th century to the present, which indicates that high debt levels undermine economic growth. This causality is supported by the law of diminishing returns, derived from the universally applicable production function. Historical declines in economic growth rates have coincided with record levels of public and private debt. Total public and private debt jumped from 167.2% of GDP in 1980 to 364.0% in 2019, with an estimated record 405% at the end of this year. Gross government debt as a percent of GDP accelerated from 32.6% in 1980 to 106.9% in 2019 to an estimated 127% by the end of this calendar year.

As proof of this connection, each additional dollar of debt in 1980 generated a rise in GDP of 60 cents, up from 54 cents in 1940. The decade of the 1980s was the last decade for the productivity of debt to rise. Since then this ratio has dropped sharply, from 42 cents in 1989 to 27 cents in 2019.

ASYMMETRIC CENTRAL BANK POWERS

Economic scholars have long argued that for monetary policy to be able to stimulate economic growth, four basic conditions must be met. First, the U.S. Federal Reserve (Fed) must be able to control the monetary base by increasing its liabilities, which are assets of depository institutions. The Fed can create these liabilities at will electronically. In the old days, textbooks said that these

IOUs were created at the "stroke of the bookkeeper's pen." These liabilities, however, do not meet the definition of money which must be a medium of exchange, store of value and unit of account. These Fed liabilities are an asset of depository institutions with an overnight maturity that remains on the books of the Fed. These liabilities can be used to trade with other banks, the Fed and the Treasury, but they cannot be used to directly purchase goods and services. When the Fed buys Treasury paper, which has an approximately seven-year average maturity in the public market, the private sector's holdings go down and the Fed's holdings of Treasury paper rise. Depository institutions are now holding an overnight liability of the Fed for which they currently earn 0.10%. The second requirement of the Fed's power to stimulate economic conditions is a stable relationship between the monetary base (a consolidation of the Fed and Treasury balance sheets) and the M2 money supply. The money multiplier, which is defined as M2 divided by the base, is the measure of that stability. Third, the velocity of money (V) must be stable, although not constant. If V is stable, then changes in M2 will control swings in nominal GDP. Fourth, the Fed must have wide latitude to lower the short-term policy interest rate. It had been long recognized that if short-term rates approached the zero bound, monetary capabilities would be diminished.

Four decades ago, the consensus view was that all of these conditions prevailed, and monetary policy was a potent tool of not only restraining economic growth, but also stimulating economic growth. Currently, of these four conditions, only the first one prevails, and it is the least important of the four. The Fed can control the monetary base by increasing its liabilities (bank reserves). The three other, and far more critical, conditions are no longer present due to the extreme over-indebtedness of the U.S. economy. Thus, monetary policy is left with one-sided capabilities (i.e., the Fed can restrain economic activity by reducing reserves and raising rates, but it is not capable of stimulating economic activity to any significant degree. The Fed can stabilize distressed financial markets through its powerful lending abilities.

Countries in a debt trap like the U.S., Japan, the United Kingdom and the Euro Area have experienced a fall in short-term interest rates to the zero bound, and in some cases into the territory of negative rates, thus eliminating the fourth criterion for monetary policy to play a stimulative role in supporting the economy.

DEBT FINANCED FISCAL PROGRAMS

Debt financed fiscal policy can provide a short-term lift to the economy that lasts one to two quarters. This was the case with the debt financed stimulus packages of 2009, 2018 and 2019. However, the benefit of these actions in 2009, 2018 and 2019, even when the amount of funds borrowed and spent were substantial, proved to be fleeting and the deleterious effects of the higher debt remained. Substantial econometric evidence indicates that debt levels as a percent of GDP in all of the major economies are well above the levels where these detrimental effects occur. The multi-trillion dollars borrowed for pandemic relief in the second quarter encouraged the beginnings of a "V" shaped recovery, but this additional debt will serve as a persistent restraint on growth going forward. When gross debt rises above 65% of GDP, economic growth is severely impacted, but the negative effects increase as the government debt rises above 65% and are acute at 90%.

Current research indicates that the government expenditure multiplier is negative after about three years, compared with estimates from 40-year-old textbooks that suggested a positive four to five range spending multiplier existed.

DISINFLATION

Secular deterioration in economic growth, a large amount of unused resources and negative

foreign conditions have led to a dramatic fall in the inflation rate. The constant debate over the preferred inflation gauge proved to be of no consequence over the sweep of the past four decades and the Fed's targeted inflation rate of the past 12 years proved to be equally inconsequential. Three of the broadest measures of inflation fell, with the consumer price index (CPI), the personal consumption expenditures (PCE) price index and the core PCE, which excludes the more volatile and seasonal food and energy prices, dropping to 3.2%, 2.8% and 2.8% in the past 40 years, respectively, down from 4.3%, 4.2% and 4.1% in the previous 40 years. The decade of the 2010s produced the lowest inflation rate for all these measures—1.8% for the CPI, 1.6% for the PCE and 1.6% for the core PCE. In spite of targeting an inflation rate of 2% for the past decade, the Fed missed its target.

The Fed is now using average rather than point targeting, but it's still just another form of targeting. The key to determining inflation is not Fed policy statements but the general equilibrium conditions that simultaneously determine the aggregate price level, real GDP and nominal GDP. This occurs when the Aggregate Demand (AD) and Aggregate Supply (AS) curves intersect. The output gap is real GDP minus real potential GDP divided by real GDP. Potential GDP is designed to reflect the trend rate of growth in economic activity. When the output gap is negative, economic theory terms this condition a deflationary gap. When deflationary gaps persist, the AS curve tends to be highly elastic, tends to remain elastic and tends to shift downward. When the AS curve shifts downward, this leads to lower aggregate prices and increased aggregate demand. In the past four decades of disinflation, the output gap was -1.60%, with a negative reading in 79% of the quarters. Even in the record long expansion from 2010 to 2019, the average output gap was -2%, with 77.5% of the quarters negative.

Another disinflationary force is that growth in the Euro Area and Japan has been even more disappointing than in the United States. In 1995, the first year of comparable data, real GDP was 4% percent greater in the U.S. than in the Euro Area. By the second quarter of 2020, U.S. real GDP was 37% greater than in the Euro Area. In 1995, U.S. real GDP was 120% greater than in Japan, but by the spring quarter of this year it was 194% greater than in Japan. The underperformance of the Euro Area and Japan, which reflects their greater debt overhang, has contributed to strength in the U.S. dollar which has diminished inflationary pressures in the U.S. In addition, weak growth in these two major areas has forced their businesses to send more goods to the U.S., thus detracting from U.S. output.

THE FISHER EQUATION AND MARGINAL REVENUE PRODUCT (MRP) OF DEBT

Falling real yields and inflationary expectations, via the Fisher equation, force government (risk-free) bond yields lower. But full application of the law of diminishing returns is also at work. Diminishing returns occur when a factor of production, such as debt capital is overused. This observation is confirmed by the decline in the marginal revenue product of debt. But economic theory demonstrates that when the MRP of a factor declines, the price received for that factor also declines. If, for example, labor is overused to the extent that MRP declines, so do wages, the price of labor. Thus, the decrease in MRP of debt due to its overuse, indicates that interest rates—the price of debt—should fall. This is exactly what is happening in all the major economies of the world that are suffering from a debt overhang. Thus, considering decreasing interest rates as an inducement for governments to spend more borrowed funds will add to the severity of the debt spiral. If policy makers are incentivized to borrow more because interest rates are low, then the MRP of debt will fall, leading to even weaker growth.

Moreover, interest rates are lowered indirectly by poorer growth and inflation, and by a further fall of the MRP of debt. Thus, the whole premise of Modern Monetary Theory is flawed at the core. Low interest rates are not a potential benefit for the economy—they are a result of the overuse of debt.

TAIL RISKS

We identify two tail risks for investors in long-term U.S. Treasury securities (bonds with maturities of more than 20 years): (1) a huge new debt-financed fiscal package and (2) a major change in the Fed's *modus operandi*. The first risk would change the short-run trajectory of the economy. This better growth, although short lived, could place transitory upward pressure on interest rates in a fashion that has been experienced many times. Over the longer run, disinflation would prevail and the downward trend in Treasury yields would resume.

The second risk would bring a rising inflationary dynamic into the picture, potentially becoming much more consequential. General disappointment with trying to solve economic underperformance by more indebtedness may crystalize along with the realization that debt will not work any better in the U.S. than in Japan, the Euro Area and many other countries. As this dissatisfaction intensifies, either de jure or de facto, the Federal Reserve's liabilities could be made legal tender, or a medium of exchange. Already, the Fed has taken actions that appear to exceed the limits of the Federal Reserve Act under the exigent circumstances clause, but so far, the Fed is still lending and not directly funding the expenditures of the government in any meaningful way. But some advocate making the Fed's liabilities spendable and a few foreign central banks have already moved in this direction. If the Fed's liabilities were made a medium of exchange, the inflation rate would rise and inflationary expectations would move ahead of actual inflation. In due course, Gresham's law could be triggered as individuals move to hold commodities that can be consumed or traded for consumable items. This would result in a massive decline in productivity, thus real growth and the standard of living would fall as inflation escalates. Lower and moderate-income households would be the most adversely affected. Velocity would rise dramatically. This would make Treasury bills and inflation-adjusted Treasury securities far more preferable compared to longer dated Treasury bonds.

As long as the federal government's policy prescription is ever higher levels of debt, the path toward disinflation will hold and long Treasury bonds will be the preferred area of the yield curve. The continuing shift in economic conditions over the past 40 years has necessitated several dramatic changes in HIMCo's yield curve positioning. We retain the flexibility to respond to changing economic conditions as we seek to position the Fund for what we believe lies ahead.

Thank you for the opportunity to manage your assets.

Sincerely,

Van Hoisington, V.R. Hoisington Jr. and
David Hoisington

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AVERAGE ANNUAL TOTAL RETURNS

FOR PERIODS ENDED SEPTEMBER 30, 2020

	Quarter*	1 Year	3 Years	5 Years	10 Years
U.S. Treasury Fund	0.07%	18.06%	13.24%	8.85%	7.94%
Bloomberg Barclays US Aggregate Bond Index**	0.62%	6.98%	5.24%	4.18%	3.64%

**Returns less than one year are not annualized.*

Data show past performance, which is not indicative of future performance. Current performance may be lower or higher than the data quoted. To obtain the most recent month-end performance data available, please visit wasatchglobal.com. The Advisor may absorb certain Fund expenses, without which total return would have been lower. Investment returns and principal value will fluctuate and shares, when redeemed, may be worth more or less than their original cost. **Total Expense Ratio: 0.69%**

Total Annual Fund Operating Expenses include operating expenses, including the management fee, before any expense reimbursements by the Advisor. **The Advisor has contractually agreed to limit certain expenses to 0.75% through at least 1/31/2021.** See the prospectus for additional information regarding Fund expenses.

Wasatch Funds will deduct a 2.00% redemption fee on Fund shares held 60 days or less. Performance data does not reflect the deduction of fees or taxes, which if reflected, would reduce the performance quoted. For more complete information including charges, risks and expenses, read the prospectus carefully.

Investing in bonds, you are subject, but not limited to, the same interest rate, inflation and credit risk associated with the underlying bonds owned by the Fund. Return of principal is not guaranteed. Interest rate risk is the risk that a debt security's value will decline due to changes in market interest rates. The interest rate is the amount charged, expressed as a percentage of principal, by a lender to a borrower for the use of assets. Even though some interest-bearing securities offer a stable stream of income, their prices will fluctuate with changes in interest rates. Inflation risk is the possibility that inflation will reduce the purchasing power of a currency, and subsequently reduce the value of a security or asset, and may result in rising interest rates. Inflation is the overall upward price movement of goods and services in an economy that causes the value of a dollar to decline. Credit risk is the risk that the issuer of a debt security will fail to repay principal and interest on the security when due. Credit risk is affected by the issuer's credit status, and is generally higher for non-investment grade securities.

An investor should consider investment objectives, risks, charges and expenses carefully before investing. To obtain a prospectus, containing this and other information, visit wasatchglobal.com or call 800.551.1700. Please read the prospectus carefully before investing.

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***The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage-backed securities (MBS) (agency fixed-rate and hybrid adjustable-rate mortgage [ARM] pass-throughs), asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) (agency and non-agency). You cannot invest directly in this or any index.*

The Wasatch-Hoisington U.S. Treasury Fund's investment objective is to provide a rate of return that exceeds the rate of inflation over a business cycle by investing in U.S. Treasury securities with an emphasis on both income and capital appreciation.

Sources: Hoisington Investment Management Co., Bureau of Economic Analysis, Congressional Budget Office, Office of Management and Budget, Bureau of Economic Analysis, U.S. Federal Reserve, economists Nathan S. Balke, Robert J. Gordon and Christina D. Romer, www.measuringworth.com, Bureau of Labor Statistics, Haver Analytics, Netherlands Bureau for Economic Policy Analysis, Bank for International Settlements, the Organization for Economic Cooperation and Development, The World Bank, The International Monetary Fund and the Brookings Institution.

Aggregate Demand (AD) is the total amount of goods and services demanded in the economy at a given overall price level and in a given time period.

The Aggregate Demand (AD) curve illustrates the relationship between economic goods demanded and the price level, assuming all else is held constant.

The Aggregate Supply Curve describes the relationship between price levels and the quantity of output that firms are willing to provide.

Aggregate Supply (AS) is the total supply of goods and services produced within an economy at a given overall price level in a given time period.

The Consumer Price Index (CPI), also called the cost-of-living index, is an inflationary indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food, and transportation. The CPI is published monthly. The headline CPI includes volatile food and energy prices, while the core CPI excludes food and energy.

The Fisher equation in economics estimates the relationship between nominal and real interest rates under inflation. It is named after Irving Fisher, who was renowned for his work on the theory of interest. In economics, this equation is used to predict nominal and real interest rate behavior.

The government expenditure multiplier captures the impact and consequences of a change in government spending. When the government expenditure multiplier is zero it means that GDP is unchanged from where it started, but government spending has risen by $1 and private spending has fallen by $1.

Gresham's law is a monetary principle stating that "bad money drives out good." For example, if there are two forms of commodity money (i.e., gold and silver coins) in circulation, which are accepted by law as having similar face value, the more valuable commodity will gradually disappear from circulation because people will hoard it. (Englishman Sir Thomas Gresham lived from 1519 to 1579.)

Gross domestic product (GDP) is a basic measure of a country's economic performance and is the market value of all final goods and services made within the borders of a country in a year.

M2 money supply consists of currency and checking accounts, consumer-type time and savings accounts and equivalent near monies, while M3 money supply consists of M2 plus business-type time deposits and less liquid near monies. Both M2 and M3 exclude monies and near monies owned by the Treasury, depository institutions and foreign banks and official institutions and IRA and Keogh balances owned by consumers.

Marginal revenue product (MRP) is the marginal revenue created by the addition of one unit of resource. MRP is calculated by multiplying the marginal physical product (MPP) of the resource by the marginal revenue (MR) generated.

The marginal revenue product of debt (MRP_D) is the ratio of GDP to debt.

Modern Monetary Theory (MMT) is a macroeconomic theory and practice that describes the practical uses of fiat currency in a public monopoly from the issuing authority, normally the government's central bank.

The monetary base is the total amount of a currency that is either circulated in the hands of the public or in the commercial bank deposits held in the central bank's reserves. This measure of the money supply typically only includes the most liquid currencies.

Per capita GDP is a universal measure for gauging the prosperity of nations. It is calculated by dividing GDP by a country's total population.

The Personal Consumption Expenditure (PCE) price index, also referred to as the PCE deflator, is a United States-wide indicator of the average increase in prices for all domestic personal consumption using a variety of data including U.S. Consumer Price Index and Producer Price Index prices. It is derived from personal consumption expenditures, the largest component of Gross Domestic Product in the National Income and Product Accounts of the Bureau of Economic Analysis (BEA). The less volatile measure of the PCE price index is the core PCE price index, which excludes the more volatile and seasonal food and energy prices.

The velocity of money (V) is defined as the rate at which money circulates, changes hands or turns over in an economy.

The yield curve is a line on a graph that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares three-month, two-year, five-year and 30-year U.S. Treasury securities. This yield curve is used as a benchmark for other interest rates, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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U.S. TREASURY FUND — TOP 10 HOLDINGS

AS OF JUNE 30, 2020

Security Name	Percent of Net Assets
U.S. Treasury Bond, 2.250%, 8/15/46	21.2%
U.S. Treasury Strip, principal only, 8/15/45	19.2%
U.S. Treasury Bond, 2.250%, 8/15/49	14.0%
U.S. Treasury Strip, principal only, 5/15/44	13.8%
U.S. Treasury Bond, 3.000%, 8/15/48	12.7%
U.S. Treasury Bond, 2.500%, 2/15/45	6.3%
U.S. Treasury Strip, principal only, 8/15/40	5.3%
U.S. Treasury Bond, 2.875%, 5/15/49	5.2%
Total	97.7%

Portfolio holdings are subject to change at any time. References to specific securities should not be construed as recommendations by the Fund or its Advisor. Current and future holdings are subject to risk.