WASATCH FUNDS

CHINA'S CURRENCY DEVALUATION

What It Means to Wasatch

ROGER EDGLEY, CFA
DIRECTOR OF INTERNATIONAL RESEARCH

RECENT DATA

After years of small-scale strengthening against the U.S. dollar, the coordinated devaluation of the Chinese yuan has come when China's economy is seeing more signs of weakness. In our view, it's hard to believe that the recent devaluation of the yuan will significantly help the Chinese economy. In addition, relative to the last several years, the yuan is still strong against the euro and the yen. This raises the question: Is there more devaluation to come?

Clearly, growth-rate expectations for China's gross domestic product (GDP) have come down (see chart below). The forecast is for 6.9% growth in 2015, versus 7.4% in 2014. Moreover, recent auto-sector and consumer data were weaker than expected. We believe the government's push for a shift to more consumption-based growth (away from investment-led growth) is still high on the agenda.

The most significant results of the yuan devaluation may be related to commodities and some of China's trading partners, as the knock-on effects from lower Chinese demand may continue to hurt certain emerging-market

CHINA
Actual/Forecasts

Indicator	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Economic Activity										
Real GDP (YoY%)	9.6	9.2	10.4	9.3	7.7	7.7	7.4	6.9	6.7	6.5
Fixed Asset Investment (YoY%)	—	—	—	—	—	—	15.8	12.0	11.6	11.5
Industrial Production (YoY%)	—	—	—	—	—	—	8.3	6.5	6.3	6.1
Retail Sales (YoY%)	—	—	—	—	—	—	12.0	10.5	10.7	11.0
Price Indices										
CPI (YoY%)	5.9	-0.7	3.3	5.4	2.7	2.6	2.0	1.5	2.0	2.4
PPI (YoY%)	—	—	—	—	—	—	-1.8	-4.3	-2.1	0.0
Labor Market										
Unemployment (%)	4.2	4.3	4.1	4.1	4.1	4.1	4.1	4.2	4.2	4.2
External Balance										
Curr. Acct. (% of GDP)	9.2	4.9	4.0	1.8	2.5	1.5	2.1	2.7	2.5	2.2
Export Trade (YoY%)	—	—	—	—	—	—	—	2.5	5.2	5.5
Import Trade (YoY%)	—	—	—	—	—	—	—	-8.0	4.5	4.0
Fiscal Balance										
Budget (%of GDP)	-0.4	-2.3	-1.7	-1.1	-1.6	-1.8	-1.8	-2.4	-2.5	-2.5

Source: Bloomberg L.P. as of August 21, 2015.

countries—where less demand for commodities such as copper, other metals and oil may slow the economies and depreciate the currencies of countries that have significant ties to China.

EQUITY MARKETS AND WASATCH

As we discussed in several of our quarterly commentaries this year, we became convinced that stock-market bubbles had formed in Shanghai and Shenzhen, which were transmitted (to a lesser extent) to Hong Kong. In the last two months, sentiment has worsened for all China-related stocks on poor data, poor equity-market behavior and intervention by the government. Therefore, we're pleased that we've maintained significant underweights to China versus our benchmarks.

As fundamental investors at Wasatch, our emerging-market approach tends to look at more domestically focused (as opposed to export-oriented) companies as a general theme. Yet we do hold some export-oriented companies in countries where, if China were to continue the yuan devaluation, the companies may well be affected. Therefore, we'll continue to watch these companies closely.

As discussed above, our relatively underweighted Chinese allocations put us in a better position if both the Chinese currency and stock markets continue to weaken. Nevertheless, we need to keep in mind that China's problems are not confined to just China itself. There are many emerging markets that are tied to China's growth. For example, Chile has seen its economy driven by copper exports, and copper prices have been generally dropping in recent years. So any incremental decrease in demand from China (which makes up as much as 20% of Chile's copper exports) would cause further pressure on the Chilean economy and currency. Other countries with similar exposure to various commodities are Peru, Brazil and South Africa, all of which may also see additional pressure on their economies and currencies if there's an extended devaluation of the Chinese yuan.

We've been wary of such potential challenges, and thus are generally less exposed to these countries versus our benchmarks. Wasatch tends to be overweighted in countries that *benefit* from lower commodity prices. For example, India is our largest country weighting in most of our emerging-market portfolios, and the country has 50% of its import balance in fuel. We've also invested in countries (e.g., Mexico and Taiwan) that have significant exports to the U.S.

We've frequently commented on our fundamental analysis leading us more to companies focused on domestic demand (in the Philippines and India, for example) where there are strong, favorable demographics. We believe this leaves us less exposed to shorter-term currency fluctuations as the secular rise of a large middle class in many of these countries produces excellent long-term growth prospects in well-run companies. These companies have been the hallmarks of the Wasatch stock-selection process.

WASATCH PORTFOLIO POSITIONING

Relative to our benchmarks, we continue to be underweighted in China and Hong Kong. We believe China is a "structural" underweight based on our quality and growth concerns. In terms of the names we do own in China, we've become more defensive. We do not think now is the time to be aggressive buyers of Chinese stocks, whether they be listed in China, Hong Kong or the U.S. In some ways, we think there are parallels with Japan in the 1990s, as that country worked its way through credit and property bubbles.

In a nutshell, our long-time underweights in China have related to: (1) our fundamental research of the companies we analyze and visit there, and (2) our concern that property and equity bubbles were forming in China earlier this year. As you may know, Wasatch generally doesn't hedge currencies in its portfolios. Nevertheless, as described above, we have strategies to deal with the ripple effects of a weaker Chinese yuan on other emerging- and frontier-market economies and currencies.

ROGER EDGLEY BIOGRAPHY

Roger Edgley is Director of International Research and the Lead Portfolio Manager for the Wasatch International Growth Fund and the Wasatch Emerging Markets Small Cap Fund. He is also a Portfolio Manager for the Wasatch Emerging Markets Select Fund. In addition, he was the Lead Portfolio Manager for the Wasatch International Opportunities Fund from 2005 to 2015. He joined Wasatch Advisors in 2002 and is a member of the Board of Directors. A native of the United Kingdom, he also holds U.S. citizenship and has many years of international investing experience.

Prior to joining Wasatch Advisors, Mr. Edgley was a principal, director of international research and portfolio manager for Chicago-based Liberty Wanger Asset Management, which managed the Acorn Funds. He was also a co-manager for the Acorn Foreign Forty Fund. Earlier, he worked in Hong Kong as a financial-services analyst for Societe Generale Asia/Crosby Securities and as an analyst for Strategic Asset Management.

Mr. Edgley has a Master of Arts in Philosophy from the University of Sussex and a Master of Science in Social Psychology with Statistics from the London School of Economics, where he was awarded a Social Science Research Scholarship. He earned a Bachelor of Science with honors in Psychology from the University of Hertfordshire. He is also a CFA charterholder.

RISKS AND DISCLOSURES

Mutual-fund investing involves risks, and the loss of principal is possible. Investing in small-cap funds will be more volatile, and the loss of principal could be greater, than investing in large-cap or more diversified funds. Investing in foreign securities, especially in emerging and frontier markets, entails special risks, such as unstable currencies, highly volatile securities markets, and political and social instability, which are described in more detail in the prospectus.

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

CFA® is a trademark owned by CFA Institute.

Wasatch Advisors is the investment advisor to Wasatch Funds.

Information in this document regarding market or economic trends or the factors influencing historical or future performance reflects the opinions of management as of the date of this document. These statements should not be relied upon for any other purpose. Past performance is no guarantee of future results, and there is no guarantee that the market forecasts discussed will be realized.

DEFINITIONS

Devaluation *is the planned or market-forced reduction in the value of a currency's exchange value. Devaluation may improve a country's balance-of-payments situation by boosting exports and reducing imports.*

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.*

© 2015 Wasatch Funds. All rights reserved. Wasatch Funds are distributed by ALPS Distributors, Inc.

WAS003843 Exp: 10/30/2016