



Wasatch-Hoisington U.S. Treasury Fund (WHOSX)

Quarterly Comments from Lead Portfolio Manager Van Hoisington,
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Open to all investors

Average Annual Total Returns For Periods Ended December 31, 2017

	Quarter*	1 Year	3 Years	5 Years	10 Years
U.S. Treasury Fund	3.48%	10.46%	2.54%	3.55%	7.35%
Bloomberg Barclays US Aggregate Bond Index**	0.39%	3.54%	2.24%	2.10%	4.01%

**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 www.WasatchFunds.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 1/31/2019.** See the prospectus for additional information regarding Fund expenses.

Wasatch Funds will deduct a 2.00% redemption proceeds 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 www.WasatchFunds.com or call 800.551.1700. Please read the prospectus carefully before investing.

OVERVIEW

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

Inflationary expectations receded during the fourth quarter as long-term U.S. Treasury bond yields declined. The 30-year Treasury bond yield dropped 0.12 of a percentage point during the period, ending the year at 2.74%. Overall, 2017 was notable for a flattening of the yield curve. Short-term rates, as measured by the two-year Treasury note, increased by about 0.70 of a percentage point while long-term rates, as measured by the 30-year Treasury bond, declined 0.33 of a percentage point.

The Wasatch-Hoisington U.S. Treasury Fund, which invests solely in U.S. Treasury securities, returned 3.48% for the fourth quarter of 2017, outperforming its benchmark, the Bloomberg Barclays US Aggregate Bond Index, which returned 0.39%. For the past six months, the Fund gained 3.88%, outperforming the Index, which returned 1.24%.

DETAILS OF THE QUARTER

Optimism is pervasive regarding U.S. economic growth in 2018. With gross domestic product (GDP) growing at more than 3% over the last three quarters, this optimism seems well-founded. That the Federal Reserve (Fed) has acknowledged the economy's health is evident: it has outlined additional hikes in the federal-funds rate over the coming year. Further, the solid 2017 economic performance of both the European Union and Japan is forecast to continue in 2018. Finally, the recent enactment of a tax cut is expected to boost U.S. economic growth in the new year. Well-regarded economic

research suggests a 2.5% to 3.5% real growth rate in 2018 with continued stable inflation. In addition, most surveys suggest a modest interest-rate increase across the entire maturity spectrum of the yield curve.

Our view of the economic environment diverges from the consensus. Our analysis of concurrent and leading economic variables, including consumers, taxes, monetary policy, and the yield curve, suggests that disappointing growth, lower inflation and, ultimately, lower long-term interest rates will characterize the new year.

As of November, consumer spending, which provides a heavy lift to U.S. economic growth, had expanded 2.7% over the past year, as measured by real personal consumption expenditures (PCE). This is similar to the past eight years of the expansion, during which real PCE averaged 2.5%. Despite that increase in spending, however, incomes failed to keep pace. Real disposable personal income rose just 1.9% over the past year. It was the ability to borrow that supported the spending increase. Because in economic terms borrowing is the opposite of saving, the saving rate for consumers dropped from 3.7% a year ago to 2.9% in November, a 10-year low.

It is remarkable that as recently as October 2015 the consumer saving rate was 5.9%. Had that rate been sustained through November 2017, the cumulative spending increase over the past 25 months would have registered only a 3.2% advance (a 1.5% annual rate) or \$496 billion. However, actual spending was \$939 billion, a 7.5% cumulative gain or 2.8% annual rate. An increase in consumer credit of \$253 billion and an actual reduction in savings of \$190 billion account for this difference. It is possible that the saving rate will continue to fall. A drop of the same magnitude in the next 25 months would mean the saving rate would be -0.1%, a possible-but-unlikely scenario. It's more likely that the saving rate begins to move up toward its historic average of 8.5%.

History suggests that the economy will register a slower rate of expansion following a low saving rate. This positive correlation between current saving and future consumption means a low saving rate should be followed by a lower level of consumption and vice versa. Therefore, considering that the only period in which the saving rate was lower than it is today was 1929-31, it is more likely that spending in the future will be in line with, or lower than, real income growth, which is currently weak.

Further, the modest 1.9% increase in real disposable income over the past 12 months will be under downward pressure in 2018 as employment growth continues to slow. Employment growth actually peaked in early 2015, expanding year-over-year by 2.3%. However, by December 2017 the rate of job growth had fallen to 1.4%. This trend is likely to persist in 2018, placing downward pressure on income gains and, therefore, on spending as well.

Conventional wisdom suggests that rising consumer confidence leads to significantly higher spending. However, plotting quarterly changes in real per-capita PCE against changes in consumer confidence from 1967 through the third quarter of 2017, it appears that consumer confidence is unreliably related to real PCE. Over this very robust sample of 202 observations, a 1% gain in confidence only boosts real per capita PCE by a minuscule 0.006%. While the correlation is positive, the relationship is not statistically significant with a coefficient of determination (R^2) of only 0.02.

Finally, borrowing should slow in 2018. The 1.25 percentage-point increase in the federal-funds rate since December 2015, and its magnified effect on short-term financing rates coupled with deteriorating loan quality, should continue to reinforce a slowdown in borrowing at the consumer level. Therefore, both the supply and demand for credit is waning. Slower borrowing and modest income expansion, along with a potential reversal in the near-historic low saving rate, means consumer spending will likely be an area of economic disappointment in 2018.

In 1820, the great economist David Ricardo (1772-1823) was asked whether it made any difference to the overall British economy if the Napoleonic Wars were financed by an increase in debt or by an increase in taxes. He theorized that the two were equivalent (the Ricardian Equivalence). However, Ricardo candidly cautioned that his theory might not be valid. Indeed, continuous streams of data and statistical computing techniques that are available today were not available in the early 1800s to test his theory.

The economics profession followed Ricardo's theory until 1936 when John Maynard Keynes (1883-1946) introduced the government-multiplier concept. It posited that \$1.00 of debt financing would expand GDP by some multiple of that amount. Keynes, like Ricardo, did not offer empirical proof for his proposition. And like Ricardo, it is doubtful he could have produced such analysis given the lack of advanced statistical computing techniques at that time.

To further analyze these theories, using data from 1950 through 2016, we developed a scatter diagram plotting the year-over-year percent change in real per-capita GDP against real per-capita gross federal debt, with lags in the debt of one and two years, equally weighting each year. We added the prior two years in order to capture any lags in the response of the economy to the changes in debt. The results of this diagram add to the evidence that Ricardo's theory was correct. The most important conclusion of this extensive data set, which excludes recessions, is that the slope of the line is negative but not statistically significant. A 1% increase in debt per capita over three years results in a slight decline in real per-capita GDP of 0.06%, and the coefficient of determination (R^2) is just 0.02. If the scatter diagram is calculated without lags, the slope is a virtually identical decline of 0.04%, with an even smaller R^2 of 0.01. In short, these results align with Ricardo's theory; although individual winners and losers may arise, a debt-financed tax cut will provide no net aggregate benefit to the macro-economy.

If the tax cuts were instead to be financed by a reduction in expenditures (revenue-neutral), then the economic growth rate would benefit to a minor degree. Since productivity is higher in the private sector than in the government sector, tax cuts should have a more favorable multiplier. In this type of revenue-neutral package, the economy would thus receive a slight boost. The tax cuts should increase incentives and efficiencies, and possibly lower the cost of capital and moderate the increase in the steady and substantial rise in federal debt.

Federal debt, however, still remains a problem since gross government debt recently exceeded 106% of GDP. A debt level above 90% has been shown to diminish an economy's trend rate of growth by one-third or more. When President Reagan cut taxes in 1981 growth ensued, but back then government debt was only 31% of GDP, an economic millennium from our present 106%. Looking forward, the Joint Committee on Taxation expects a \$451 billion revenue gain from improved growth over the next 10 years, yet it still expects the recent tax bill to add \$1.1 trillion to the deficit. The Congressional Budget Office expects a \$1.5 trillion increase in the deficit over the same period. According to some private forecasters, due to the front-loading of some provisions, for the next two years the federal deficit will be rising—moving from roughly 3.6% of GDP in fiscal 2017, to 3.7% of GDP in fiscal 2018, and to 5% of GDP in 2019. Thus, the continuing debt buildup will have the unintended consequence of

slowing economic growth in 2018 and beyond, despite the favorable multiplier contribution that individual tax cuts impart.

Although the economy may slow due to a poor outlook for consumer spending and increases in debt, the real roadblock for economic acceleration in 2018 is past, present and possibly future monetary-policy actions. The Fed first began raising the federal-funds rate in December 2015. A year later, the Fed implemented another 0.25 percentage-point increase. Three more similar rate hikes occurred in 2017. To raise interest rates, the Fed takes actions that reduce the liquidity of the banking system. These actions have historically caused a reduction in the supply of credit through tighter bank-lending standards. The demand for credit is also diminished as some borrowers are priced out of the market or can no longer meet the higher quality standards.

The impact of this tightened Fed policy on money, credit and eventually economic growth is slow but inexorable. The brunt of these past and current policy moves probably will be felt in 2018. Irving Fisher provided the arithmetic formula that money times its turnover equals price times transactions, or nominal GDP ($MV=PT$). This simple equation provides a roadmap of ebbing growth next year. Velocity (V) is currently low. At 1.43, velocity is standing at its lowest level since 1949, well below the 1.74 average since 1900. Money (as defined by M2) expanded by 7% in 2016. Owing to Fed actions, money growth slowed to a 5% year-over-year growth rate at the end of the third quarter of 2017, a 2.5% reduction from the previous year. In the fourth quarter of 2017 the Fed planned to reduce its balance sheet by \$30 billion, an action we term “quantitative tightening” (QT). This action has and will continue to put additional downward pressure on money growth; a \$60 billion reduction is expected in the first quarter of 2018, a \$90 billion reduction is expected in the second quarter of 2018, and a further \$270 billion reduction is expected following the second quarter of 2018. It is important to note that historical comparisons and analysis are unavailable as the magnitude of this balance-sheet reduction is unprecedented. However, the three-month growth rate of money has already slowed further to 3.9% at the end of 2017.

In the 1960s, economists Karl Brunner (1916-1989) and Allan H. Meltzer (1928-2017) both proved $M2$ equals the monetary base (MB) times the money multiplier (m) ($M2=MB*m$). They also algebraically identified the determinants of m . Application of their model, which has been verified by numerous others, suggests the monetary slowdown will intensify, thereby increasing the drag on economic growth, as 2018

unfolds. If the Fed continues QT for one year as outlined, we calculate the overall change in M2 could turn negative by the end of the year. If money (M2) continues to decelerate, and V stabilizes (although it has declined at a 2.4% rate over the past eight years), then nominal GDP will record a lower growth rate in 2018 than the estimated 2017 pace of 4.0%.

The determinants of short-term interest rates are far different than those of long-term interest rates, thus causing the shape of the Treasury yield curve to significantly change shape over the course of the business cycle.

Changes in long-term Treasury bond yields are determined by the Fisher equation, one of the pillars of macroeconomics. In this equation, the nominal risk-free bond yield equals the real yield plus expected inflation ($i=r+\pi^e$). Expected inflation may be slow to adjust to reality, but the historical record indicates that the adjustment inevitably occurs.

Although very volatile over the short run, the real rate can be stable over longer time spans; inflationary expectations ultimately dominate the longer-run movements in the Treasury bond yield. The Fisher equation can be rearranged algebraically so that the real yield is equal to the nominal yield minus expected inflation ($r=i-\pi^e$).

Short-term interest rates are determined by the intersection of the demand and supply of credit that the Fed largely controls by shifting the monetary base and interest rates. The higher funds rate can be reached by a slower-but-still-positive growth rate in the monetary base or by an outright decline in the base. When the base money becomes less available, the upward sloping credit supply curve shifts inward, thus hitting the downward sloping credit demand curve at a higher interest-rate level.

Restrictive monetary policy affects the economy through several observable phases, all of which take time to work. Initially, the monetary shift causes the federal-funds rate to rise. As mentioned earlier, as the federal-funds rate moves higher, the growth rates of the monetary and credit aggregates slow. A sign that this restrictive process is beginning to more meaningfully affect monetary conditions is that the yield curve begins to flatten, with short-term rates rising relative to long-term rates. Historically, as the yield curve flattens, the profitability of the banks and all similarly structured entities is diminished from this influence. Thus, while the change in the curve initially is a symptom of monetary tightness, the flatter curve then reinforces the earlier monetary restraint.

OUTLOOK

The full spectrum of monetary policy is aligned against stronger growth in 2018. A higher federal-funds rate, the continuation of QT, low velocity and abruptly slowing money growth all put downward pressure on economic growth. The flatter yield curve will further tighten monetary conditions. This monetary environment coupled with a heavily indebted economy, a low-saving consumer and well-known existing conditions of poor demographics suggest 2018 will bring economic disappointments. Inflation is likely to subside along with growth, causing lower long-term Treasury yields. Such conditions should be favorable for the Fund's investments in long-term U.S. Treasury bonds.

Thank you for the opportunity to manage your assets.

Sincerely,

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

***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.*

Correlation in statistics is a quantity measuring the extent of interdependence of variable quantities.

The credit supply curve is a tool used by economists to measure the availability of credit in an economy. On a graph, the credit supply curve is upward sloping.

The credit demand curve is a tool used by economists to measure the demand for credit within an economy. On a graph, the credit demand curve is downward sloping.

A credit aggregate measures the stock of bank loans outstanding at a point in time.

The federal-funds rate is the interest rate at which private depository institutions (mostly banks) lend balances (federal funds) at the Federal Reserve to other depository institutions, usually overnight. It is the interest rate banks charge each other for loans.

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.

The Joint Committee on Taxation is a nonpartisan committee of the United States Congress, originally established under the Revenue Act of 1926.

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.

The money multiplier (*m*) is the expansion of a country's money supply that results from banks being able to lend. The size of the multiplier effect depends on the percentage of deposits that banks are required to hold as reserves. In other words, it is money used to create more money and is calculated by dividing total bank deposits by the reserve requirement.

Personal consumption expenditures (PCE) is the primary measure of consumer spending on goods and services in the U.S. economy. It accounts for about two-thirds of domestic final spending, and thus it is the primary engine that drives future economic growth. Real PCE is after prices have been adjusted for inflation.

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.

U.S. Treasury Fund Top 10 Holdings as of September 30, 2017	Percent of Net Assets
Security Name	
U.S. Treasury Bond, 2.250%, 8/15/46	35.7%
U.S. Treasury Strip, principal only, 8/15/45	21.5%
U.S. Treasury Bond, 2.500%, 2/15/45	17.2%
U.S. Treasury Strip, principal only, 5/15/44	10.4%
U.S. Treasury Strip, principal only, 8/15/40	5.7%
U.S. Treasury Bond, 3.750%, 11/15/43	4.6%
U.S. Treasury Bond, 3.125%, 8/15/44	2.3%
U.S. Treasury Bond, 2.500%, 5/15/46	2.1%
Total	99.4%

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

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