Animal Spirits

January 11, 2017
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U.S. Stocks Mostly Rose in the Aftermath Of Donald Trump's Election. Our Response Is to *Lean Against the Wind.*

In his 1936 book *The General Theory of Employment, Interest and Money*, John Maynard Keynes used the term "animal spirits" to describe the instincts, proclivities and emotions—rather than rational thoughts—that influence human behavior in the economy and financial markets.

While I believe that acting based on rational thoughts is the best way for investors to achieve their long-term goals, I agree with Keynes that animal spirits often rule the day in the short term. Moreover, I note that even though animal spirits are generally associated with euphoria, these spirits can turn sour and drive asset prices lower.

Benjamin Graham, a pioneer in fundamental investing, put it another way: "In the short run, the market is a voting machine but in the long run, it is a weighing machine." Here, Graham was saying that a voting machine measures the fickle attitudes of investors—while a weighing machine measures the cold, hard facts.

Beyond these metaphors, we just witnessed the surprising verdict of our own real-life "voting machine." Most investment analysts didn't predict that Donald Trump would be elected president. And if they had, very few would have anticipated the post-election rally in U.S. stocks that actually occurred.

I believe this rally was the result of animal spirits based on the notion that Trump's pro-growth policies will support the economy. At the same time, many investors assume that growth in the economy will lead to upticks in inflation and interest rates, which—along with lighter regulations—are perceived as positive for business.

In general, the rally since the election didn't play to the strengths of our high-quality, non-index-like focus at Wasatch Funds. Although many of our funds moved up during the post-election period, we lagged our benchmarks in most cases.

At the same time that U.S. stocks benefited from animal spirits in the aftermath of Trump's election, other markets were subjected to losses. For example, long-term Treasury bonds suffered particularly large declines, while intermediate-term bonds and even short-term bonds also fell. These losses primarily resulted from the widespread belief that interest rates have embarked on a path of continual increases, as highlighted by the Federal Reserve's December move to hike the federal-funds target rate and by the signal that three more rate hikes are likely in 2017. Elsewhere, emerging-market stocks weren't immune to losses either.

So, how should investors respond to the current environment? Should they chase the recent winners in the financial markets? Our approach at Wasatch is to *lean against the wind*. In other words, we're sticking with our process and we're maintaining a skeptical view of investments that may have gotten ahead of themselves.

ECONOMY

Prior to the U.S. election, I suggested that the next president would matter less than many voters had hoped or feared. My reasoning was that bureaucracy and political checks and balances cause most new policies to be implemented slowly and incrementally. Moreover, as I discussed in a previous "Message to Shareholders," a new administration is a relatively small force compared to the massive effects of global disinflationary pressures, aging demographics and declining productivity growth.

Since the election, contrary to my own view, the prevailing view in the financial markets has been that big changes are in store for the U.S. economy. So, let's start by considering several conditions that I believe aren't likely to be altered much by a Trump presidency.

First, there's the employment situation. The jobless rate is already down to 4.6%, which is the lowest since August 2007 and is at a level most economists consider indicative of "full employment." While government stimulus under a Trump administration could bring some job rotation and better pay to those currently employed, such gains might be offset by higher wage costs for businesses.

Second, the U.S. government faces a heavy debt burden, which has risen to a level that can no longer be ignored. This burden would likely be exacerbated by Trump's proposed tax cuts and spending increases.

Third, in most developed countries, including the United States, older citizens comprise an increasing proportion of the population. And since many of these citizens are unprepared for retirement, they're likely to prioritize saving over spending—a situation that doesn't support strong economic growth, no matter who's president. Moreover, older Americans are likely to resist any inflationary policies put forth by a Trump administration because inflation is harmful to people such as retirees living on fixed incomes.

Fourth, there's been speculation that interest rates will rise meaningfully under a Trump presidency. But given the global savings glut, rate increases in the U.S. would likely boost the value of the dollar and draw in foreign capital seeking higher returns. Such a situation would probably not be sustainable because a strong dollar is already hurting the competitiveness of U.S. exports, and because a flood of foreign capital would drive interest rates back down.

Fifth, many conservatives believe Republican control of the White House and both branches of

Congress will lead to smooth sailing in Washington, D.C. Let's not forget, however, the dashed hopes of many liberals who were similarly optimistic when President Barack Obama took office with a perceived overwhelming mandate. In addition, we need to remember that Hillary Clinton did, in fact, win the popular vote. And her supporters aren't likely to fold under Republican pressure.

Another disconnect regarding the supposed unity among Republicans is that many of Donald Trump's campaign promises run counter to party orthodoxy. Take international trade, for example. Some of his positions sound a lot more like those of Bernie Sanders than of Ronald Reagan.

Now, let's consider the conditions that I believe *will* experience more significant changes after Trump's inauguration. And while the following changes could be meaningful, I still don't think they'll leave the country in a vastly improved situation once the dust settles. This is because the U.S. economy has already performed reasonably well compared to most other developed countries. During the third quarter, for example, U.S. gross domestic product expanded at a real, seasonally adjusted rate of 3.5%—which was the strongest growth rate in two years.

Perhaps Trump's number one change will be to deal with the large amount of corporate capital stashed overseas. Many American corporations are reluctant to repatriate that capital to the United States because it would face additional taxes. Lowering or temporarily eliminating the taxes on repatriated capital seems likely, as such a move has support on both sides of the aisle. Having said that, repatriated capital won't necessarily have a dramatic impact on domestic business activity because a lack of capital hasn't been the main reason for corporations' reluctance to spend. In fact, many companies have been using the capital they already have to repurchase shares rather than make new investments.

Number two—the incoming administration is likely to make some progress on rolling back regulations. But Trump ran on a populist agenda, and I think many of his supporters will have little sympathy for the likes of "fat cat" bankers and "big pharma" executives looking to save money through regulatory reforms.

Number three—Trump will probably feel compelled to deliver on infrastructure projects. And the Democrats will likely go along because infrastructure spending has been on their agenda since the end of the global financial crisis. The scope of the spending, however, could be limited by the country's budget deficit and mounting national debt—as well as by environmental considerations, which are often influenced more by "not in my backyard" attitudes than by political-party affiliations.

MARKETS

Now that I've presented my views regarding what to expect from a Trump presidency, let's look at how various U.S. stock indices performed during the fourth quarter, which was dominated by the post-election period. In general, it's clear that many stocks became less correlated with each other in the aftermath of the election. While this was good for recent market darlings, it also means that these same stocks may be prone to sharp reversals if reality fails to meet or exceed expectations.

The large-cap S&P 500® Index gained 3.82% during the quarter. As an indication of small-cap performance, the Russell 2000® Index rose a robust 8.83%. And because they're perceived as more sensitive to Trump's economic policies, value-oriented stocks did even better, as evidenced by the 14.07% increase of the Russell 2000 Value Index.

International stocks, during the fourth quarter, produced mixed returns—which we see in the modest -0.36% loss of the MSCI World Ex-U.S.A. Index. But if we confine our gaze to less-developed countries, we notice that the MSCI Emerging Markets Index declined a disappointing -4.16%, with stocks in some countries getting hit much harder.

Perhaps the biggest surprise—mostly because many investors don't understand the inherent risks in bonds—was the performance of long-term Treasuries. To illustrate, the Barclays U.S. 20+ Year Treasury Bond Index fell a whopping -12.16% during the quarter. To put that in perspective, at the start of the quarter, long-term Treasuries yielded about 2%. So the loss of more than 12% during the quarter ate up about six years of anticipated interest payments.

To a large extent, the performance shown above was driven by cash movements subsequent to the presidential election, as animal spirits caused many U.S. investors to prefer equities in a big way and to dump bonds. For example, cash movements for U.S. equity and sector equity mutual funds led to an inflow of $34 billion during November, reversing an average monthly outflow of $6.5 billion for the 12 months ended October 31, 2016. Conversely, cash movements for U.S. taxable and municipal bond mutual funds led to an outflow of $13 billion during November, even though the previous 12 months saw an average monthly inflow of $18 billion.

Beyond these overall cash movements for mutual funds, animal spirits supported certain indices and sectors more than others. Investors who are tempted to pile into areas where prices have risen the most may want to consider that many corporate insiders in these areas have been selling. *InsiderScore.com,* a company that provides research for investors on insider trading, institutional ownership and stock buybacks, reported that executives, directors and beneficial owners recently sold more shares than they purchased at a ratio about double what's considered bearish.

For our part, as described above, we're sticking to the Wasatch investment process. In the current environment, that means leaning against the wind—maintaining positions in our favorite holdings, looking for opportunities in areas that have been left behind, staying diversified, and resisting the temptation to chase performance. This process served us well in other emotionally charged environments, such as during the periods surrounding the dot-com bubble that topped in 2000 and the real-estate mania that peaked in 2006.

With sincere thanks for your continued investment and for your trust,
Sam Stewart

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 frontier and emerging 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.

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DEFINITIONS

Someone who is "bearish" or "a bear" is pessimistic with regard to the stock market's prospects.

The federal-funds target rate (also known as the fed-funds target rate) is set by a committee within the Federal Reserve System called the Federal Open Market Committee (FOMC). The FOMC usually meets every six weeks, and it is at these meetings that the FOMC votes on whether or not to make changes to the federal-funds target rate.

The financial crisis of 2008-09, also known as the global financial crisis (GFC) and 2008 financial crisis, is considered by many economists to have been the worst financial crisis since the Great Depression of the 1930s.

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. Real GDP is a macroeconomic measure of the value of economic output adjusted for price changes (i.e., inflation or deflation). This adjustment transforms the money-value measure, nominal GDP, into an index for quantity of total output.

The S&P 500 Index includes 500 of the United States' largest stocks from a broad variety of industries. The Index is unmanaged, but is a commonly used measure of common stock total-return performance.

The Russell 2000 Index is an unmanaged total-return index of the smallest 2,000 companies in the Russell 3000 Index, as ranked by total market capitalization. The Russell 2000 is widely used in the industry to measure the performance of small-company stocks.

The Russell 2000 Value Index measures the performance of Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

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The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging market countries. With 832 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI World Ex-U.S.A. Index captures large and mid cap representation across 22 of 23 developed market countries—excluding the United States. With 1,004 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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The Barclays U.S. 20+ Year Treasury Bond Index measures the performance of U.S. Treasury securities that have remaining maturities of 20 or more years.

You cannot invest directly in these or any indices.