WELLS FARGO Asset Management

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PORTFOLIO MANAGER COMMENTARY

Overview, strategy, and outlook

As of September 30, 2019

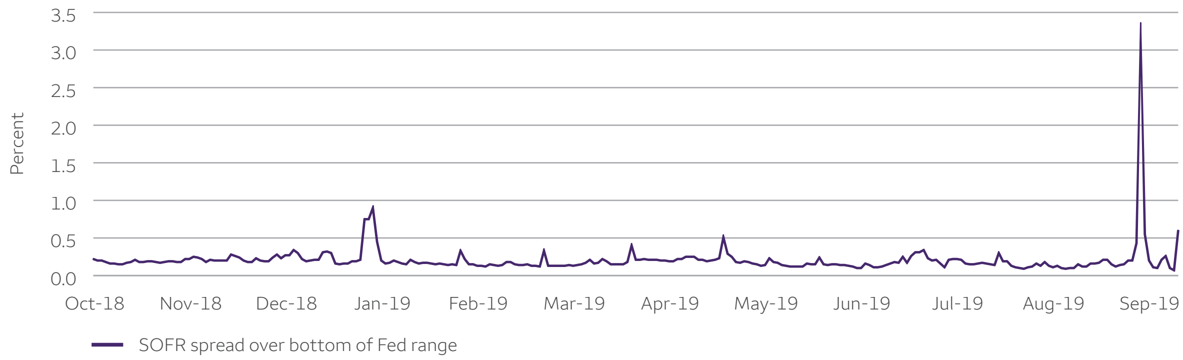
Money market overview

U.S. government sector

Generally, what happens in the money markets stays in the money markets. They can seem a bit arcane, they're viewed by the business world as benign but necessary plumbing, and their various markets and mechanisms would be incomprehensible to the general public. So if something happens there that not only makes the business press but moves beyond it into the general media, it must have been noteworthy. Such was the case with the repurchase agreement (repo) market volatility in mid-September. The executive summary of events is that repo rates spiked higher, catching the attention not only of the Federal Reserve (Fed) but also of the media. While the Fed moved promptly to inject liquidity into the system by offering its own repo deal to primary dealers, it took a few days to get the details properly calibrated. Eventually the Fed drove repo rates down to relative levels not seen in over a year.

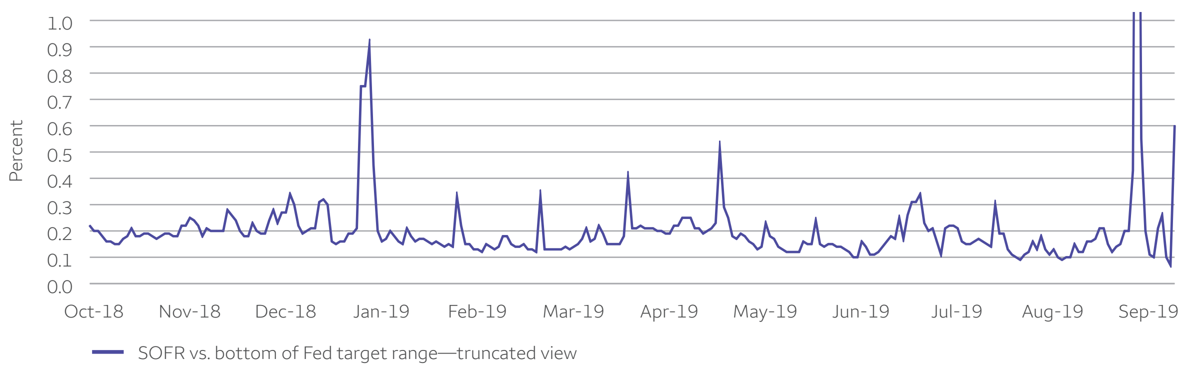
The two charts on the next page show repo rates over the past year, using the Fed's Secured Overnight Financing Rate (SOFR)[1]. The first highlights the extremity of the recent move, while the second presents the same data scaled differently, with the recent "top" chopped off to give a sense of what had previously been normal volatility. In each case, the repo rates are compared with the bottom of the Fed's target range.

SOFR vs. bottom of Fed target range



Sources: Federal Reserve Bank and Bloomberg L.P.

SOFR vs. bottom of Fed target range—truncated view



Sources: Federal Reserve Bank and Bloomberg L.P.

The occurrence of repo rate volatility is fairly routine and often predictable based on expected changes in supply stemming from Treasury security settlements, which occur at the middle and end of each month, or changes in demand, when excess cash either enters or leaves the market for purposes such as making tax payments. Additionally, repo rates have tended to react to dealer window dressing on financial reporting dates, typically moving higher on month-ends, higher still on quarter-ends, and peaking at year-ends. Given that we see these events fairly regularly, the idea that the confluence of Treasury settlements and corporate tax payments on the same day, September 16, would push repo rates higher was no surprise. Obviously the magnitude of the move was. What was different this time, resulting in such a wildly different market reaction?

Believe it or not, as with so many things in the money markets, you have to go back to the financial crisis to get to an answer. Here's a quick rundown: Reacting to the crisis, the Fed engaged in quantitative easing—buying Treasury and mortgage securities to spur the economy. In doing so, by adding the securities to its balance sheet, it effectively created excess reserves in the banking system. The Fed was then operating in an ample reserves regime, which meant plenty of liquidity in the system to be strategically redeployed into higher-yielding alternatives if they arose, for instance into the repo market when rates periodically moved higher. As the Fed embarked on the journey over the past few years to unwind its crisis measures by shrinking its balance sheet, thus reducing its securities holdings and reserves, its desired destination was to *"hold no more securities than necessary to implement monetary policy efficiently and effectively"*[2]—in other words, to have reserves that were just ample enough. But the destination was not marked on the map, and it was possible they wouldn't recognize it until they had passed it, which they happened to do on September 16.

In an efficient market free of external constraints, rational actors would have seen the higher repo rates that day and redeployed cash to take advantage of them, preventing them from moving significantly higher. But on that day, they obviously didn't since rates kept climbing, leading one to conclude that banks with deployable cash must simply have already deployed their last available dollar, leaving borrowers searching for funding at higher and higher rates. The answer to the question of what was different this time is that banks had reached the lowest level of reserves they felt comfortable holding. Unsurprisingly, this is also a product of the financial crisis, as robust banking regulations enacted afterward encourage large banks to hold larger amounts of reserves. Fed Governor Lael Brainard explained the attractiveness of reserves in a speech in March:

> *. . . the demand from commercial banks for deposits at the Fed—that is, "reserves"—appears to have increased substantially. Spurred by new liquidity regulations and their own internal liquidity management practices, the largest banks hold substantial amounts of so-called high-quality liquid assets to protect against the risk of a sudden "run" on their uninsured short-run liabilities, as occurred during the financial crisis.*[3]

The Fed's initial response was to engage in an open market operation (OMO), offering to be an overnight repo counterparty to primary dealers for up to $75 billion, effectively providing that amount of funding to a market hungry for it. In addition to daily OMOs thereafter, the Fed executed three separate two-week repo operations in the ensuing weeks to keep a firm grip on the market over the approaching quarter-end. Between $139 billion in term operations and the $63.5 billion in the daily OMO that day, the Fed provided a total of $202.5 billion of liquidity to the market over quarter-end. The result was to drive SOFR down to 1.82% on September 27, just 0.07% above the bottom of the Fed's target range, the lowest such spread in over a year. Although rates did move higher on September 30, with SOFR at 2.35%, the move was entirely consistent with typical quarter-end market behavior.

The Fed may have been left a bit red-faced by the spike in repo rates, partly because it calls into question its ability to control short-term rates, which is central to the transmission of monetary policy, and partly because regulators have been touting SOFR as an acceptable reference rate to replace LIBOR (the London Interbank Offered Rate). It took a few days to get the response right, but after adding the term operations, the Fed demonstrated the control it desired. Its next step will be to take more permanent measures to avoid the need for the temporary OMOs it used this time around. Among the leading contenders are a standing repo facility, which we discussed earlier this year here, or a resumption of asset purchases. The latter is perhaps the leading contender, as it addresses both sides of the repo market in one fell swoop: by regularly buying Treasuries, the Fed would help ease the glut of them residing on dealer balance sheets, thus reducing repo supply, while at the same time growing its own assets, which increases reserves. Expect an announcement from the Fed at its next meeting at the end of October, if not sooner.

Prime sector

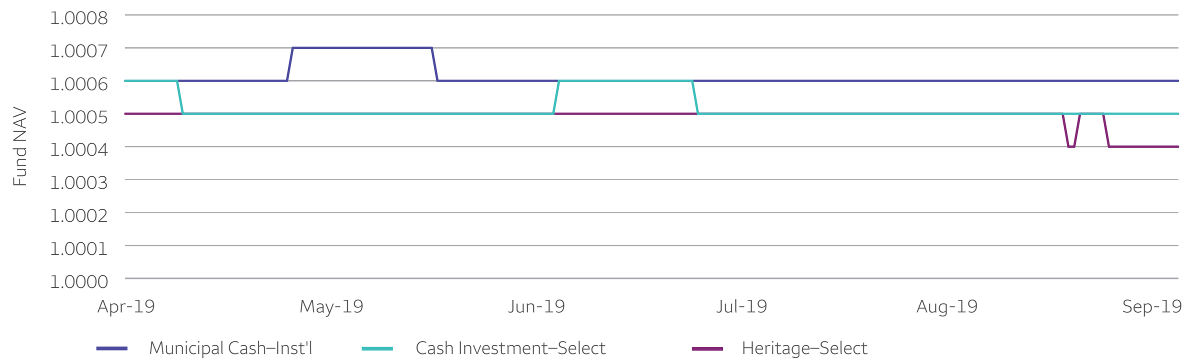
For the second consecutive meeting, the Federal Open Market Committee (FOMC) reduced the federal funds target range by a quarter-percentage point to 1.75% to 2.00%, a move that was both expected and fully priced into the market. In addition to the 25-basis-point (bp)[4] cut to the target range, the FOMC reduced both the reverse repo rate (RRP) and the interest on excess reserves (IOER) by 30 bps to 1.70% and 1.80%, respectively, in an effort to keep the effective funds rate within its target range. The accompanying statement discussed the impacts to growth from trade conflicts, weak global growth, and the continued weakness in manufacturing, while also acknowledging that the consumer remains the economy's driving engine. There was even greater dissension within the ranks at this meeting compared to the last—three dissenters compared to two in July. Those two members would have liked to see no change to the target rates, while one would have preferred a larger 50-bp reduction to the target. The Fed's economic assessment was little changed from the July meeting, with household spending seen rising at a strong pace and job gains solid. Messaging since the September meeting has been relatively hawkish, with several Fed speakers emphasizing that the two mid-cycle rate cuts might be enough for now, and one (Chicago Fed President Charles Evans) asserting that the Fed does not need to take any more action on risks that have not materialized.

Following its meeting, the FOMC released its quarterly Summary of Economic Projections (SEP, or dot plot) and left many of its projections either unchanged or with minor adjustments from the previous quarter's assessment. Committee members continue to downplay the correlation of these projections with the actual path of policy rates and economic data and have been communicating these projections more as a tool to frame market discussions. However, we still view these projections as an important input when developing our views around market expectations of the FOMC's future actions. The current SEP shows gross domestic product expectations revised up 0.10% for 2019 to 2.20%, unchanged for 2020 at 2.00%, and raised slightly for 2021 at 1.90%. Inflation and inflation expectations remain unchanged from the June assessment and still slightly below the FOMC's stated goal of being symmetrical around 2.00% for 2019 and 2020. The median target federal funds rate forecast for 2019 and 2020 dropped to 1.875% from 2.375% and 2.125%, respectively, from the June assessment. Even though the median rate dot plot shows 2019 finishing in the current federal funds range, seven members have an additional rate cut baked into their forecasts. At the press conference, Fed Chair Powell remained noncommittal in his policy guidance and stuck to the script that policy is not a preset course. Federal funds futures currently agree with the seven members that another cut is expected by the end of the year.

The mid-month repo kerfuffle (discussed in the Government section above) had little impact on commercial paper rates. Overnight and very short paper felt some pressure at the time as each product is competing in the prime space for the same investment dollars. However, term commercial paper rates rose and fell incrementally in line with changes in LIBOR as the repo phenomenon was largely viewed as a short-term, supply-driven situation. Issuers in general were pretty well funded before quarter-end and therefore didn't need to pay a hefty premium to attract investment. Going forward, what should start to affect commercial paper levels is the looming year-end. Issuers typically prefer to be assured of being properly funded over year-end well beforehand and will pay a premium to attract investments to avoid year-end funding pressures. These funding pressures, coupled with uncertainty over the path of policy rates, might cause term levels to rise and widen further relative to LIBOR.

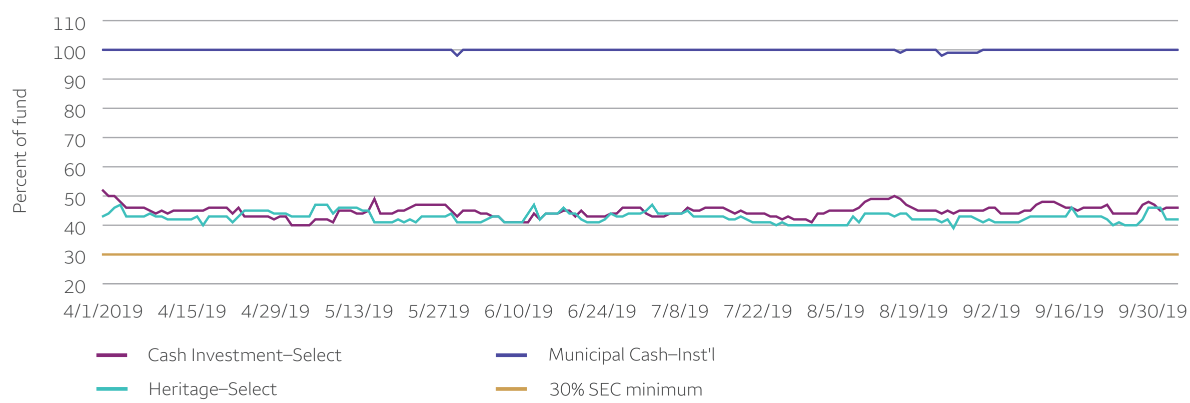
At the portfolio level, we have opportunistically extended weighted average maturities by adding fixed-rate paper to the portfolios when the breakeven yield calculations were attractive while adding floating-rate securities when LIBOR is elevated or swap spreads widen. Even so, we have maintained our high level of liquidity and relatively short weighted average maturities[5], which should help mitigate pricing pressures on our net asset values (NAVs).

Wells Fargo floating net asset value (FNAV) money market fund NAVs



Source: Wells Fargo Funds

Wells Fargo FNAV money market fund weekly liquid assets



Source: Wells Fargo Funds

Municipal sector

Despite the cut in benchmark rates by the FOMC on September 18, yields in the short end of the tax-exempt yield curve actually rose throughout the month based on technical weakness in the municipal space. While asset levels in the Crane Tax-Exempt Money Fund Index[6] stabilized during the month, new issue supply in both the money and bond markets drove short-end rates higher, exacerbating the inverted money market yield curve. The Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index[7] rose for three straight weeks to close out the month at 1.58%, up from 1.35% the previous month. With municipal and taxable rates heading in opposite directions, the SIFMA to 1-week LIBOR ratio rose to an attractive 83%, up from 63% at the end of August. Further out on the curve, yields on high-grade fixed-rate paper in 1-month to 6-month paper rose 10–15 bps to the 1.30 area. In the 1-year space, yields on high-grade benchmark issues, such as Texas tax and revenue anticipation notes (TRANs)[8], rose roughly 15 bps to the 1.30 area as well.

During the month, we continued to target our purchases in variable-rate demand notes (VRDNs)[9] and tender option bonds (TOBs)[10] with daily and weekly puts in order to take advantage of the inverted yield curve while continuing to emphasize principal preservation and liquidity. The inverted yield curve in the municipal space has allowed us to enjoy the benefits of higher current short-term rates without the need to extend the weighted average maturity of our portfolios. We continue to feel that the short end of the municipal yield curve offers potential value in terms of attractive nominal and after-tax returns for municipal investors.

On the horizon

Money market funds have exhibited exceptional growth since the beginning of the year. Crane Data indicates $604 billion has flowed into the funds since December 31, bringing overall balances to $3.758 trillion! This is not quite a record for balances though: Money market fund assets peaked on January 14, 2009, at $3.922 trillion. The growth this year has been split between government funds and prime funds. Remarkably, prime fund asset growth has exceeded government fund growth by 50%, with government funds adding $221 billion and prime funds drawing $303 billion. It seems reasonable to assume that volatility in other sectors of the markets may have a hand in driving asset growth. Anecdotally, it seems that volatility has been ratcheting up this past quarter, especially in September. It's not surprising then to see that over 71% of the asset growth can be accounted for by flows during the third quarter.

So what can we expect going forward? With the House seemingly resolved to swiftly conclude its official impeachment inquiry by the end of the year, the fourth quarter could see more of the same type of volatility as the White House's economic agenda stalls and economic policies that are negatively affecting markets (such as trade wars) remain unresolved. And that doesn't include the effects of negative stories that inevitably accompany any sort of investigative processes. At the same time, investors are increasingly uncertain over the direction of the Fed's policy path. So, we're preparing for a bumpy fourth quarter in risk assets. On the flip side, money markets historically tend to be a relative oasis of calm and largely unaffected by those types of goings-on. If investors decide to de-risk going into year-end, the fourth quarter, which has historically been a period of growth for money market funds in general, may see larger flows than in years past. Who knows—maybe we'll hit another high in money market fund assets this year. Stay tuned!

Rates for sample investment instruments—current month-end % (September 2019)

Sector	1 day	1 week	1 month	2 month	3 month	6 month	12 month
U.S. Treasury repos	2.35	1.90	–	–	–	–	–
Fed reverse repo rate	1.70	–	–	–	–	–	–
U.S. Treasury bills	–	–	1.83	1.81	1.78	1.78	1.70
Agency discount notes	1.72	1.74	1.80	1.83	1.83	1.79	1.59
LIBOR	1.82	1.91	2.02	2.07	2.09	2.06	2.03
Asset-backed commercial paper	1.98	2.01	2.09	2.12	2.12	2.02	–
Dealer commercial paper	2.05	2.02	1.92	1.91	1.93	1.94	–
Municipals	1.79	1.58	1.30	1.30	1.30	1.30	1.30

Sources: Bloomberg L.P. and Wells Capital Management
Past performance is no guarantee of future results.

Wells Fargo Fund	7-day current yield
Cash Investment MMF*–Select	2.07%
Heritage MMF*–Select	2.08%
Municipal Cash Management MMF*–Inst'l	1.46%
Government MMF**–Select	1.88%
Treasury Plus MMF**–Select	1.87%
100% Treasury MMF**–Inst'l	1.84%

Source: Wells Fargo Funds

Figures quoted represent past performance, which is no guarantee of future results, and do not reflect taxes that a shareholder may pay on a fund. *Yields will fluctuate. Current performance may be lower or higher than the performance data quoted and assumes the reinvestment of dividends and capital gains. Current month-end performance is available at the funds' website, wfam.com.*

Money market funds are sold without a front-end sales charge or contingent deferred sales charge. Other fees and expenses apply to an investment in the fund and are described in the fund's current prospectus.

The manager has contractually committed to certain fee waivers and/or expense reimbursement through May 31, 2020. Brokerage commissions, stamp duty fees, interest, taxes, acquired fund fees and expenses (if any), and extraordinary expenses are excluded from the expense cap. Without these reductions, the seven-day current yield for the Institutional Class of the Cash Investment Money Market Fund, Heritage Money Market Fund, Municipal Cash Management Money Market Fund, Government Money Market Fund, Treasury Plus Money Market Fund, and 100% Treasury Money Market Fund would have been 1.95%, 1.98%, 1.35%, 1.80%, 1.79%, and 1.81%, respectively, and the total returns would have been lower. Prior to or after the commitment expiration date, the cap may be increased or the commitment to maintain the cap may be terminated only with the approval of the Board of Trustees. The expense ratio paid by an investor is the net expense ratio (the total annual fund operating expenses after fee waivers) as stated in the prospectus.

For more information, please contact:

Institutional Sales Desk: **1-888-253-6584**

Website: **wfam.com**

(Click "Select Your Role" in the top navigation and select "Institutional Cash Investor")

1. The Secured Overnight Financing Rate (SOFR) is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities.
2. https://www.federalreserve.gov/newsevents/pressreleases/monetary20140917c.htm
3. https://www.federalreserve.gov/newsevents/speech/brainard20190307a.htm
4. 100 bps = 1.00%
5. Weighted average maturity (WAM): An average of the effective maturities of all securities held in the portfolio, weighted by each security's percentage of total investments. The maturity of a portfolio security is the period remaining until the date on which the principal amount is unconditionally required to be paid, or in the case of a security called for redemption, the date on which the redemption payment is unconditionally required to be made. WAM calculations allow for the maturities of certain securities with demand features or periodic interest rate resets to be shortened. WAM is a way to measure a fund's sensitivity to potential interest rate changes. WAM is subject to change and may have changed since the date specified.
6. The Crane Tax Exempt Money Fund Index is a simple average of municipal or tax-exempt money market funds tracked by Crane Data (currently 185 funds). This index is published in the Crane Money Fund Intelligence newsletter, MFI XLS and MFI Daily products. Crane Data has been publishing information and indexes on money market funds since 2006. Visit www.cranedata.com for more information. You cannot invest directly in an index.
7. The Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index is a seven-day high-grade market index composed of tax-exempt variable-rate demand obligations with certain characteristics. The index is calculated and published by Bloomberg. The index is overseen by SIFMA's Municipal Swap Index Committee. You cannot invest directly in an index.
8. Tax and revenue anticipation notes are short-term debt securities issued by a municipal government to finance an immediate project that will be repaid with future tax collections or revenue generated by that same project.
9. Variable-rate demand notes (VRDNs) are debt securities commonly held within the Wells Fargo Money Market Funds. Like all bonds, VRDN values fluctuate in response to the financial condition of individual issuers, general market and economic conditions, and changes in interest rates. Changes in market conditions and government policies may lead to periods of heightened volatility in the bond market and reduced liquidity for certain bonds. In general, when interest rates rise, bond values fall and investors may lose principal value. Interest rate changes can be sudden and unpredictable. In addition to credit and interest rate risk, VRDNs are subject to municipal securities risk.
10. A tender option bond (TOB) is a type of VRDN where a long-term bond is placed into a trust. Floating-rate securities are created from the trust.

**For floating NAV money market funds: You could lose money by investing in the fund. Because the share price of the fund will fluctuate, when you sell your shares they may be worth more or less than what you originally paid for them. The fund may impose a fee upon sale of your shares or may temporarily suspend your ability to sell shares if the fund's liquidity falls below required minimums because of market conditions or other factors. An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The fund's sponsor has no legal obligation to provide financial support to the fund, and you should not expect that the sponsor will provide financial support to the fund at any time.*

For retail money market funds: You could lose money by investing in the fund. Although the fund seeks to preserve the value of your investment at $1.00 per share, it cannot guarantee it will do so. The fund may impose a fee upon sale of your shares or may temporarily suspend your ability to sell shares if the fund's liquidity falls below required minimums because of market conditions or other factors. An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The fund's sponsor has no legal obligation to provide financial support to the fund, and you should not expect that the sponsor will provide financial support to the fund at any time.

***For government money market funds: You could lose money by investing in the fund. Although the fund seeks to preserve the value of your investment at $1.00 per share, it cannot guarantee it will do so. An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The fund's sponsor has no legal obligation to provide financial support to the fund, and you should not expect that the sponsor will provide financial support to the fund at any time.*

For the municipal money market funds, a portion of the fund's income may be subject to federal, state, and/or local income taxes or the alternative minimum tax. Any capital gains distributions may be taxable. For the government money market funds, the U.S. government guarantee applies to certain underlying securities and not to shares of the fund.

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