Wells Fargo Money Market Funds

WELLS FARGO Asset Management

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PORTFOLIO MANAGER COMMENTARY

Overview, strategy, and outlook

As of December 31, 2019

The year in review

While most of the year we focused on the Federal Reserve (Fed), we took three opportunities to engage in a more in-depth discussion on specific topics affecting the money markets. In February, we examined the state of the credit environment, examining both relevant asset classes as well as regional differences. In May, we discussed what was on the horizon for the United Kingdom after it missed its Brexit deadline and Prime Minister Theresa May resigned. And finally, as talk of an impending recession ramped up, in August we focused on the typical expected behavior of money market funds in a recessionary environment.

But the Fed and its actions dominated our monthly commentaries this year, and for buy-siders it was not for reasons we particularly liked. After nine tightening moves, beginning with lifting the target federal funds rate off its zero bound in December 2015, the Fed signaled at its December 2018 meeting that it might be pausing by noting it was changing its data-dependent stance to one emphasizing “patience,” a development we discussed in January along with the effect on the various money market sectors. As the quarter progressed, by March the market seemed to be coming to the conclusion that the odds of an ease were increasing the longer an increasingly dovish Fed remained on pause. At the same time, the Fed began exploring ideas to manage a ceiling on rates—this time in the form of a standing repo facility. In April, with federal funds trading at the top of the range and the Fed seemingly treading water, discussion centered more on a cut in interest on excess reserves to try to bring federal funds back toward the middle of its range. Then, in June it became clear that the Fed had lost all patience and completed a dovish pivot. The yield curve had inverted and the prospect of at least three eases was built into near-term pricing. And, as expected, those eases followed in quick succession, beginning at the July meeting, continuing into September, and culminating in the end of its “mid-cycle adjustments” at the October meeting. Complicating matters were the repo market dislocations experienced in September, prompting the Fed to focus the remainder of the year on managing liquidity and the level of reserves as it remained on policy sidelines.

Sector views

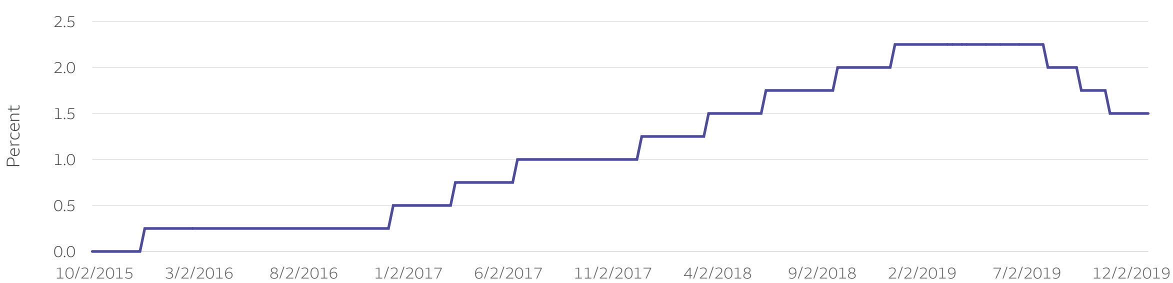
U.S. government sector

Former Fed Chair Janet Yellen began to normalize monetary policy in October 2017 after years of crisis-fighting had left interest rates abnormally low and the Fed's balance sheet abnormally large. By the time she "passed the book" to current Fed Chair Jerome Powell in February 2018, interest rates were back above 1% and on a steady march higher, and the balance sheet was on a transparent, pre-planned decline. Under Chair Powell, the Fed continued both endeavors throughout 2018, and as we look back at the end of 2019, it's apparent that the Fed overshot "normal" on both, although neither overshoot was necessarily clear at the time. The story of 2019 was the Fed's recognition it had gone too far as well as the steps it took to find a new, easier normal.

The Fed's last interest rate hike, in December 2018, brought its federal funds rate target range to 2.25% to 2.50%. An equity market pullback around that time pushed the "pause" button on the hiking cycle and then trade tensions erupted in May, rattling supply chains worldwide and injecting dreaded uncertainty into business planning. The first May domino was the breakdown in trade talks between the U.S. and China, and the second was the U.S. threat to impose tariffs on Mexico to encourage immigration cooperation. The modest global slowdown that followed spurred the Fed to lower rates by 25 basis points (bps)[1] at three consecutive meetings, from July to October, with the target range ending the year at 1.50% to 1.75%. 2019's mid-cycle adjustment suggests the Fed went a few steps too far in raising rates. In its defense, though, its monetary policy stance at the beginning of the year may well have been appropriate, with little indication then that trade disputes would become so disruptive to global business activity.

Through it all, the U.S. consumer continued to spend (it is peerless in that regard), and we believe that exceptionally low unemployment combined with the new, easier interest rates leave the economy well positioned heading into 2020. The chart below shows the recent rate cuts in the context of the entire move away from zero interest rates.

Federal funds target rate lower bound



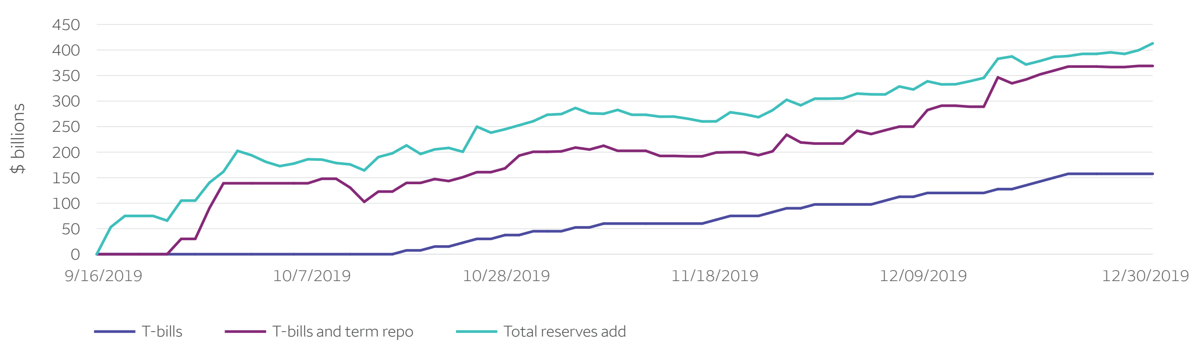
Source: Bloomberg L.P.

Even as the Fed ceased raising rates in the first half of 2019, it continued to normalize its balance sheet, letting securities it bought during its crisis-era quantitative easing programs mature and roll off. However, when the Fed cut rates for the first time in July, it also decided to halt its balance sheet normalization. Maturing securities would be reinvested, and the portfolio would therefore remain the same size. There are a lot of moving parts to the Fed's balance sheet, but the long and short of it is that, at the time, there was no reason to think the Fed had overshot its goal of a "normal" balance sheet. Unfortunately, it had, in fact, blown by it like Maverick's F-14 buzzing the control tower in *Top Gun*. This finally became clear in mid-September, when regular Treasury auction settlements coincided with a corporate tax payment date and reserves in the system were apparently inadequate to meet the cash needs of borrowers in the repo market, leading repo rates to soar to as high as 10%.

The question of how the Fed could have whiffed so badly by over-shrinking its balance sheet is only obvious in hindsight. Historical data probably gave the Fed comfort that reserves were still well within a reasonable range. For example, excess reserves before the financial crisis were typically less than $10 billion in total. In the post-crisis years, they rose to over $2.70 trillion before falling to $1.262 trillion at the time of the mid-September fireworks. Likewise, the Fed's securities portfolio, which totaled around $800 billion pre-crisis and rose to $4.25 trillion at its post-crisis peak, was still nearly $3.60 trillion at the time the Fed ceased normalization. Given these still apparently abnormally large measures, what the Fed missed was that banking regulations imposed after the crisis led banks to hold reserves in a way they hadn't before the crisis. As a result, reserves the Fed thought were ample were, in fact, scarce.

It's unlikely the Fed enjoyed having egg on its face so publicly with repo rates straying so far out of its range, and it attacked the problem with a vengeance, determined to not have a recurrence at year-end. It directly injected cash into the repo market by engaging in overnight and term repo operations, and it began growing its balance sheet again in October by buying Treasury bills. As shown below, the combined effect of these efforts was to add $413 billion in reserves at year-end, including $157 billion in Treasury bill (T-bill) purchases.

Fed reserves operations



Source: Federal Reserve Bank of New York

Given its motivation, available tools, and sheer size, it should come as no surprise that the Fed succeeded: Since beginning its operations, repo rates have been exceptionally subdued. The Secured Overnight Financing Rate (SOFR),[2] the Fed's comprehensive repo index, has routinely spiked on certain heavy supply days, such as Treasury settlement days, or on month- and quarter-ends. In the first 10 months of 2019, the SOFR registered more than 30 bps over the bottom of the Fed's target range 10 times, and it averaged 19 bps over the range bottom in that period. In 2019's last two months, its highest "spike," a molehill really, was 15 bps, and it has averaged 6 bps over the range bottom. On the last day of the year, the SOFR was 1.55%, just 5 bps over the range bottom, compared with the 90-bp spike at the end of 2018.

In summary, 2018 was about normalization, and 2019 was about correcting the overshoot of normalization. 2020 dawns with the Fed firmly in control of interest rates at a level it considers appropriate. It's possible that at least part of 2020 will be about the Fed relinquishing some control over the repo market to allow market forces to play more of a role, so long as those forces are well behaved.

Prime sector

The money market sector is heavily influenced by the Federal Open Market Committee's (FOMC's) assessment of the economy, its target rates, and expectations of changes to those target rates. Consequently, we try to glean insight about rate moves by dissecting Fed statements and Fed member speeches and by analyzing the Summary of Economic Projections (SEP).

Even as the economic landscape was showing signs of sputtering growth toward the end of 2018, the FOMC raised rates in December. It quickly became apparent, however, that it would be the last move in the tightening cycle that had begun two years earlier. The Fed led us into 2019 indicating that the December rate increase might be the last for a while. But expectations were that the economy was still chugging along even if that chugging was at a less robust pace. It seemed reasonable to assume that it got us to where we needed to be, at a target rate level low enough to not extinguish growth and perhaps let inflation rise to the 2% target but high enough to trim the wings a little. Patience was the key word introduced to the lexicon. And after a pause to refresh, rates might continue back on its higher track.

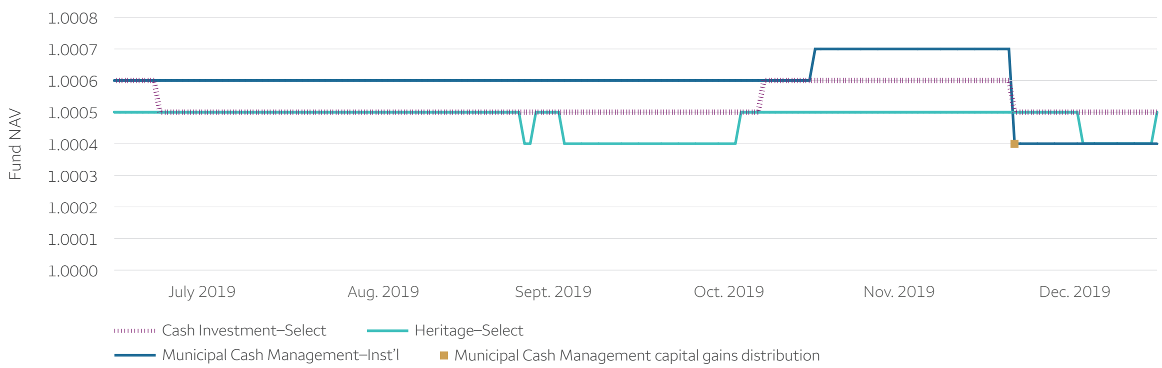
The patient pause didn't last long. By March, the SEP had turned dovish with no participants expecting a hike and one anticipating a cut. Other signs pointing to the possibility this was not just a pause was the tightening of the London Interbank Offered Rate (LIBOR) Overnight Interest Swap rate (LOIS)[3] from its relatively wide spread of 42.5 bps at the end of 2018, hitting a low of 14.5 bps in June. By May, more indicators confirmed that this was not a pause on the way to higher rates. In fact, it was looking like a pause in front of lower rates. While household spending and business fixed investment were slowing, personal consumption expenditures had ticked up and nonfarm payrolls came in strong. Overshadowing everything were trade tensions as negotiations with China, Mexico, Japan, and Europe broke down in various forms. With the central question of what would be the economic impacts of tariffs and trade wars unanswered, equities sold off and a flight to quality occurred. U.S. Treasury yields fell 34–36 bps, with 2-, 3-, and 5-year notes all yielding less than 2%. At that point, federal funds futures were showing more than a 70% chance of a 25-bp cut at the September FOMC meeting.

At the June FOMC meeting, the Fed downgraded its growth assessment from solid to moderate and removed the word patient from its statement, focusing on increased uncertainties in the outlook. The SEP showed a downward shift in rates expectations and seemed to be queuing up for an ease at the conclusion of the July FOMC meeting. Sentiment had seemingly turned on a dime. The consumer was still consuming but the trade tensions and weak business sector had participants asking if a recession was looming.

Fast forward to year-end with a total of three consecutive easings—in July, September, and October—and maybe, just maybe, the FOMC executed the perfect landing. Chair Powell set a high bar for further rate cuts after the October move, saying the cumulative easing to date will continue to provide support for the economy as monetary policy stimulus traditionally operates with a lag. That high bar was reiterated in December when it was made clear that the Fed expected to be on hold possibly through the election.

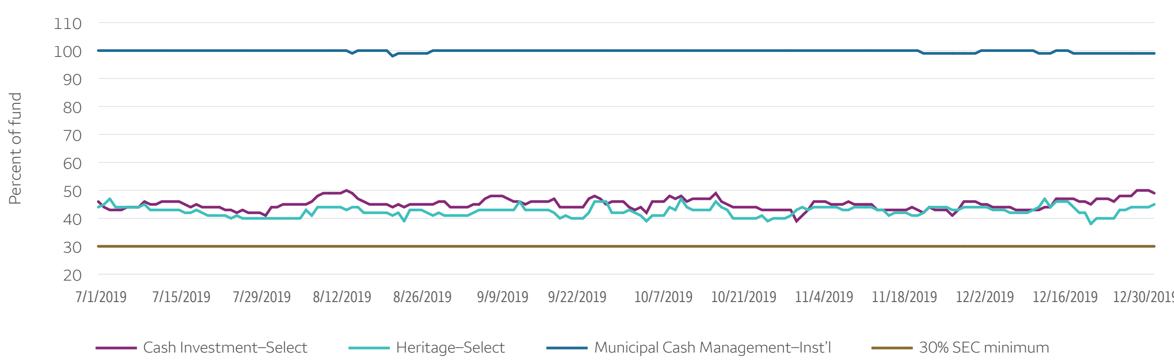
At the close of 2019, we are still focused on a few unresolved items that will influence markets next year, namely Brexit, trade issues and tariffs, the conclusion or continuation of temporary Fed liquidity operations, Fed T-bill purchases and other quantitative easing measures, and finally, the election. With the Fed appearing to be on hold for now, credit fundamentals continue to be supportive and the yield curve is slightly positively sloped. As a result, prime funds have extended weighted average maturities[4] and weighted average lives.[5] While we, too, have pursued this strategy, we continue to favor portfolios emphasizing highly liquid, high-quality assets while opportunistically adding longer-dated fixed- and floating-rate securities to capture greater risk-adjusted returns, all while minimizing net asset value (NAV) volatility.

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

The municipal money market space continued to be influenced by a combination of macroeconomic factors, the lingering effects of 2017 tax reform, and typical seasonality throughout the year. During the year, municipal money market rates generally tracked taxable equivalent rates lower as the Fed embarked on its easing policy with three cuts to the federal funds rate in July, September, and October. The overall municipal market has also been affected by the tremendous shift in investor appetite for tax-advantaged municipals following the tax reform policy implemented at the end of 2017. Longer-dated municipal bond funds experienced record-setting inflows as investor demand shifted further out on the curve. Conversely, municipal money market funds experienced roughly $6.0 billion in outflows throughout the year as tax-exempt to taxable ratios experienced significant pressure due to continuing supply and demand imbalances.

In the short end of the municipal money market sector, the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index[6] began the year at 1.71%, or 71% of 1-week LIBOR, but began to quickly grind lower as seasonal cash inflows reinvigorated demand for overnight and weekly variable-rate demand notes (VRDNs)[7] and tender option bonds (TOBs).[8] Throughout the year, the supply/demand dynamic for VRDNs and TOBs experienced typical seasonal swings. For example, during tax time, the SIFMA Index spiked to a multi-year high of 2.30% (95% of 1-week LIBOR) on April 24. The SIFMA Index would experience other patches of weakness around quarter-ends, in sympathy with taxable equivalents. The SIFMA Index spiked from 1.40% at the beginning of June to 1.90% by quarter-end. Similarly, the index spiked to 1.58% at the end of September, up from 1.28% at the beginning of the month. Absolute levels slowly drifted lower as the FOMC continued to cut rates during the fall. However, at year-end, the SIFMA Index would spike to 1.61%, or 99% of 1-week LIBOR, up from 1.06% at the beginning of the month, due to year-end pressures.

Further out on the curve, the municipal money markets were generally immune to the volatility experienced in the overnight and weekly sectors. Demand for high-grade paper in the one-year area remained consistently strong throughout the year. Yields on high-grade paper in the one-year space began the year at roughly 1.90% but drifted lower as the year progressed. By late June, one-year paper had fallen to a low of approximately 1.30% as note season came into full effect. In August, the state of Texas issued $8 billion in tax and revenue anticipation notes in the 1.25%–1.32% range. The largest deal of the year was priced to attract both money market funds and longer-term investors. After the three rate cuts by the Fed, though, market participants began to price in the prospects of an FOMC on hold. Accordingly, one-year yields closed out the year at roughly 1.14%.

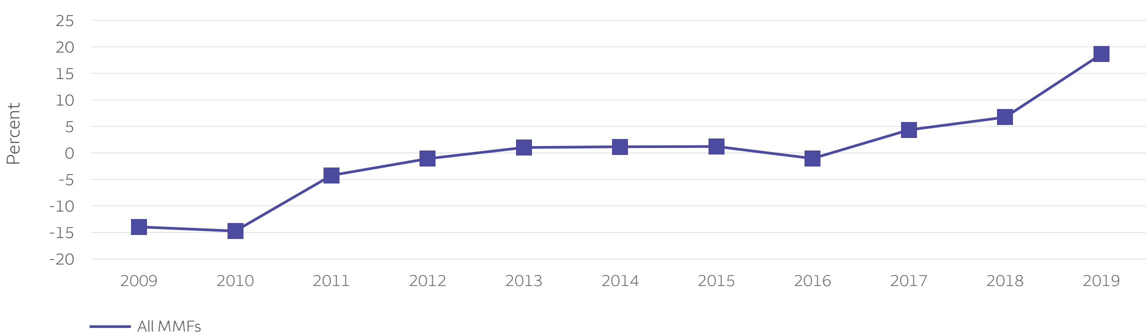
Throughout the year, we continued to emphasize portfolio liquidity by targeting our purchases predominantly in daily and weekly VRDNs and TOBs. This strategy allowed us to achieve our objectives for maintaining high degrees of weekly liquidity and principal preservation. Additionally, our strategy allowed to us to quickly capture the benefits of elevated SIFMA rates during periods of seasonal volatility. Given the relative flatness of the municipal yield curve, we continued to adopt a conservative posture with respect to liquidity and duration targets throughout 2019. However, we did opportunistically add exposure to fixed-rate paper in the one-month to six-month range.

On the horizon

"Auld Lang Syne" is traditionally associated with the end of one year and the beginning of the next and can be interpreted to mean "for the sake of old times." The poem, and especially the song, is usually interpreted as a call to remember old friendships and times gone by, and with its strong association with New Year's Eve, it frequently prompts reflection on the past year. But along with the year in review, it's also a good time to review the past decade, as befits a year ending in "9."

In that context, for the money market fund industry as a whole, the story of the year was "growth." As the chart below illustrates, money market funds achieved their fastest growth in the past 10 years—growing by 18.6% this year. This is remarkable in that for much of the past decade, funds have experienced growth that can be charitably characterized as anemic, at around 1% or less—when it wasn't negative—and only in the previous two years had growth exceeded 4%.

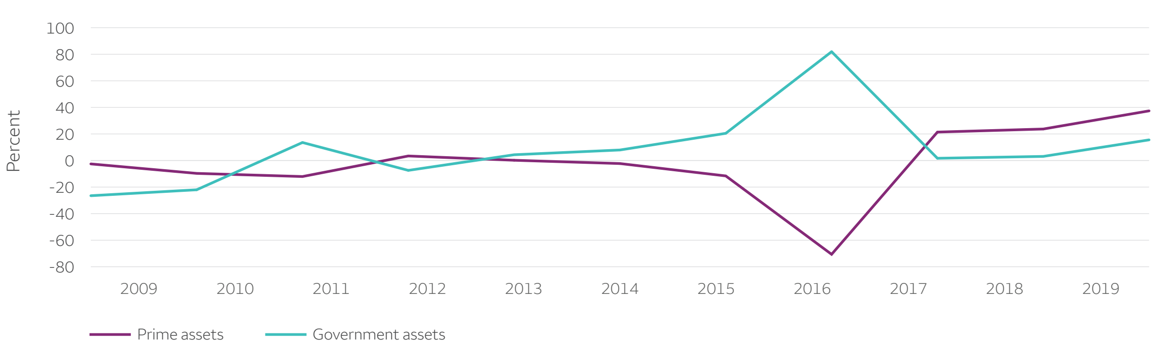
Money Market Fund industry asset growth



Source: Investment Company Institute and Bloomberg L.P.

The next chart shows the growth of prime and government/Treasury/repo funds. Following a rotation out of prime funds and into government funds spurred by the implementation of money market reforms in October 2016, prime funds were left with only $380 billion in assets. As of December 31, 2019, they had more than doubled in size to $777 billion—and grew an astonishing 37% this year alone! To be sure, government funds also contributed to overall industry growth, clocking in just under the industry growth at 15.5%.

Prime and government funds' growth



Source: Investment Company Institute and Bloomberg L.P.

So where do we go from here? Optimistically, up! The trend seems to favor continued growth, as do economic conditions and market volatility. Additionally, we are entering a cyclical time of year in which funds traditionally gather assets in advance of tax payments coming due in April. Beyond that, the crystal ball is a little cloudy, but if the next year is anything like the past three, we could see continued asset growth in our industry.

Happy New Year!

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

Sector	1 day	1 week	1 month	2 month	3 month	6 month	12 month
U.S. Treasury repos	1.55	1.53	–	–	–	–	–
Fed reverse repo rate	1.45	–	–	–	–	–	–
U.S. Treasury bills	–	–	1.42	1.46	1.51	1.54	1.52
Agency discount notes	1.24	1.29	1.43	1.51	1.53	1.48	1.58
LIBOR	1.54	1.63	1.76	1.82	1.90	1.91	1.99
Asset-backed commercial paper	1.63	1.62	1.71	1.82	1.90	1.90	–
Dealer commercial paper	1.68	1.69	1.66	1.67	1.66	1.81	–
Municipals	1.65	1.61	1.10	1.10	1.10	1.10	1.14

Sources: Bloomberg L.P. and Wells Capital Management

Wells Fargo Fund	7-day current yield
Cash Investment MMF*–Select	1.68%
Heritage MMF*–Select	1.72%
Municipal Cash Management MMF*–Inst'l	1.45%
Government MMF**–Select	1.49%
Treasury Plus MMF**–Select	1.48%
100% Treasury MMF**–Inst'l	1.44%

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, to cap the funds' total annual fund operating expenses after fee waivers. 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 1.64%, 1.69%, 1.34%, 1.48%, 1.45%, and 1.41%, 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.

Wells Fargo Money Market Funds

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1. 100 bps = 1.00%
2. The Secured Overnight Financing Rate (SOFR) is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities.
3. The LIBOR-OIS (LOIS) is the spread between the 3-month LIBOR (the London Interbank Offered Rate) and the Overnight Indexed Swap (OIS). The LOIS spread represents the difference between an interest rate with some credit risk built in and one that is virtually risk free.
4. 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
5. Weighted average life (WAL): An average of the final maturities of all securities held in the portfolio, weighted by their 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. The calculation of WAL allows for the maturities of certain securities with demand features to be shortened but, unlike the calculation of WAM, does not allow shortening of the maturities of certain securities with periodic interest-rate resets. WAL is a way to measure a fund's potential sensitivity to credit spread changes. WAL is subject to change and may have changed since the date specified.
6. 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.
7. Variable-rate demand notes (VRDNs) are debt securities commonly held within the 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.
8. 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.

The views expressed and any forward-looking statements are as of December 31, 2019, and are those of the fund managers and the Money Market team at Wells Capital Management, subadvisor to the Wells Fargo Money Market Funds, and Wells Fargo Funds Management, LLC. Discussions of individual securities, the markets generally, or any Wells Fargo Fund are not intended as individual recommendations. Future events or results may vary significantly from those expressed in any forward-looking statements; the views expressed are subject to change at any time in response to changing circumstances in the market. Wells Fargo Asset Management disclaims any obligation to publicly update or revise any views expressed or forward-looking statements.

Carefully consider a fund's investment objectives, risks, charges, and expenses before investing. For a current prospectus and, if available, a summary prospectus, containing this and other information, visit wfam.com. Read it carefully before investing.

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