WELLS FARGO Asset Management

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PORTFOLIO MANAGER COMMENTARY

Overview, strategy, and outlook

As of February 29, 2020

Credit overview

We experienced another year of generally benign credit conditions in 2019. The market was fairly positive, but central bank policy, geopolitical concerns, and various idiosyncratic risks kept investors on their toes. Likewise, environmental, social, and governance (ESG) factors have come into greater focus both internally and across the global investment landscape.

Rating agency upgrades outnumbered downgrades in 2019, continuing a trend that has been in place since 2013. For the year, there were 1.52 upgrades for every downgrade in investment-grade (IG) corporates, 2.51 upgrades for every downgrade in IG financials, and 1.08 upgrades for every downgrade in IG nonfinancials. The performance for financials was the strongest since the financial crisis and their gap to nonfinancials was also at its widest since the crisis.

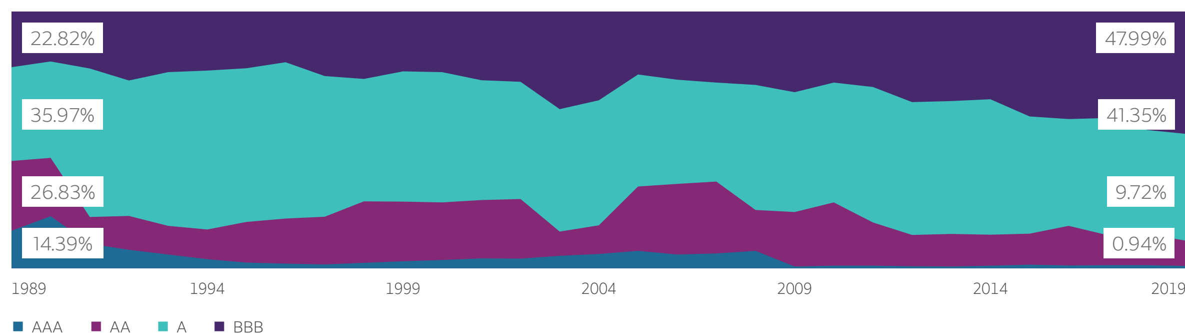
Upgrade/downgrade ratio, 2000–present

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total corporates	1.05	0.46	0.33	0.46	1.61	1.61	2.21	2.63	0.29	0.29	0.50	0.73	0.36	0.86	1.88	1.37	1.09	1.14	1.72	1.52
Financials	1.63	0.49	0.36	0.56	2.03	1.85	4.62	4.10	0.20	0.12	0.33	0.98	0.27	0.82	1.98	1.95	1.51	0.96	2.25	2.51
Nonfinancials	0.74	0.44	0.36	0.8	1.43	1.73	1.13	1.57	0.67	0.35	0.96	0.39	0.51	0.99	1.87	0.89	0.79	1.34	1.37	1.08

Sources: Bloomberg L.P. and Wells Capital Management Inc.

Taking advantage of the friendly credit environment and continued low interest rates, debt issuance was healthy in 2019. The Bloomberg Barclays U.S. Corporate 1–5 Year Bond Index[1] topped $2 trillion in market value for the first time. The growth was driven by the A and BBB buckets, which each grew at 5% and pushed the total index up 2% for the year. AAA credits fell 19% and now represent less than 1% of the index. AA credits fell 17% and are now less than 10% of the index. BBB credits now make up 48% of the index, or $918.7 billion, a record high.

U.S. corporate credit quality, unhedged, 1989–2019



Sources: Bloomberg L.P. and Wells Capital Management Inc.

On the short end of the yield curve, a few isolated downgrades dropped some commercial paper (CP) issuers out of the A-1/P-1 category and were largely confined to nonfinancials. Overall, CP outstandings grew during the year, primarily driven by foreign issuers. Foreign nonfinancial issuance was up 19% and foreign financial issuance was up 15%. Asset-backed commercial paper (ABCP) and tier-2 CP were effectively flat.

Commercial paper outstanding—not seasonally adjusted (in $billions)		Dec. 2019	June 2019	Dec. 2018
Total		1045.2	1090.4	996.0
Nonfinancial		252.2	310.4	229.3
	Domestic	194.4	236.6	180.8
	Foreign	57.8	73.8	48.5
Financial		537.4	537.5	512.7
	Domestic	215.0	237.8	232.2
	Foreign	322.4	299.7	280.5
ABCP		254.8	242.5	253.5
Tier 2		74.4	83.6	73.7

Source: Federal Reserve

Global macro trends

In its most recent World Economic Outlook, the International Monetary Fund pegged global growth at 2.9% for 2019, a downward revision from the prior forecast. The growth rate for developed economies was forecasted at 1.7%, also a downward revision, reflecting trade uncertainty, geopolitical unease, and softness in emerging markets. More recently, the coronavirus has been casting its shadow upon 2020 growth projections, increasing the likelihood of more accommodative monetary policy in the process.

United States

The U.S. economy is stable, with reported growth of 2.3% for 2019 and unemployment at 3.5%. Budget deficits remain elevated, estimated at 4.7% of gross domestic product for the year, and debt levels continue to climb, with year-end public debt outstanding at $23.2 trillion.

The Federal Reserve (Fed), largely in response to trade uncertainty, ended its hiking cycle and began to ease rates with three 25-basis-point cuts during the year. Another notable Fed action came in response to the repo market disruption in September when the central bank added over $400 billion in overnight and term funding via open market operations. The action was successful in calming repo markets through year-end. Coronavirus concerns and election-year uncertainties will add more intrigue to Fed decisions in 2020.

Brexit

On January 31, 2020, three and a half years after its historic vote to leave the European Union (EU), the U.K. exited the EU and began a transition period that will last through the end of the year. Although there were few changes during the transition period, of interest to markets will be the progress the two sides make in negotiating agreements to replace EU rules and regulations. The scope of new agreements is extensive, and the balance of the year may prove insufficient time to hammer it all out, particularly since some of the issues are quite contentious. It is possible that, at the end of the year, the U.K. operates under World Trade Organization rules, which could be disruptive to business and weaken economic growth. While negotiations are set to get underway soon, the U.K. could request an extension, which it would have to do by July 1. This is, however, unlikely given the Conservative Party's decisive win in the December 2019 election was based on a "get Brexit done" manifesto. By the summer, it should be clearer whether the two sides will come to constructive agreements in 2020.

European Union

The EU looks poised for subdued growth overall, with continued divergence among countries. The slowdown in Germany and France in 2019 may turn around in 2020, but ongoing economic, fiscal, and political stresses in Italy are likely to remain a source of risk to euro-area performance. Ireland is entering new political territory after the success of Sinn Fein in the general election upended decades of two-party dominance by right-center parties. With the three parties each receiving 20%+ of the vote, the process of forming a new government could be complex and drawn out. Downside risks to EU economies are increased by external factors as well, including unpredictable global trade policies, upcoming negotiations with the U.K. related to Brexit, and the potential impact of the coronavirus.

U.S.-China trade war

Since 2018, the U.S. and China have been engaged in a protracted trade conflict. The U.S. imposed its first tariffs on $34 billion of Chinese imports with the total eventually reaching $360 billion. China responded with tariffs of its own and, not surprisingly, global growth suffered in 2019. On the positive side, though, the January 2020 signing of a Phase One interim trade deal has deescalated tensions, though the two sides remain far apart on numerous more structural issues.

Coronavirus

The novel coronavirus, which originated in the Chinese city of Wuhan, has quickly spread across the Chinese mainland and beyond. While transparency and credibility of data from China are questioned and authorities' efforts to contain the virus are debated, worldwide cases and deaths continue to escalate. Favorably, the coronavirus appears to be much less lethal than SARS or MERS, and a majority of cases can be classified as mild. However, its rate of infection or spread is considerably higher. With quarantined cities, restricted travel, and business closures, economic expansion is expected to be severely affected in the first quarter. While the hope is that the virus will peak and be contained by the end of March, there remains a great deal of uncertainty about the spread of the disease, its management, and the ultimate economic impact.

Financial institutions

U.S. banks led the broadly positive credit tone in 2019. Capital and liquidity metrics remain strong, and asset quality continues to be steady in most regions. The reversal in interest rates last year pressured earnings for the group. To counter this pressure, virtually all banks in our universe are pursuing strategies like digitization, expense control, fee income growth, and capital-efficient organizational alignment. The transition from the London Interbank Offered Rate to the Secured Overnight Financing Rate remains a focus across the sector as well.

North America

As in many jurisdictions, key risks to monitor include asset valuations, leverage, and debt levels across corporations, households, and governments. Asset quality remains robust, however—as does liquidity and capital. The interest rate environment remains a challenge for most companies' net interest margins but banks continue to work on their efficiency ratios via expense control and the pursuit of other income opportunities. Several money center banks saw rating agency upgrades this year, and we saw one of the largest banking mergers since the financial crisis.

Canadian banks continue to exhibit healthy asset quality, good regulatory capitalization, and comfortable profitability. With an economy tethered to the U.S., the United States–Mexico–Canada trade agreement nearing closure, and a continuation of low interest rates, the Canadian consumer should fare reasonably well in the year ahead. However, we will continue to monitor elevated home prices and high household debt as potential headwinds.

Europe

For the majority of European banks, capital and liquidity remain a strength. Asset quality is less strong, but not deteriorating. Negative interest rates are a constant pressure for institutions across the region, and as with other global counterparts, expense control was a key focus for European institutions this year. Anti-money laundering concerns in the Nordic sector were a source of headlines, while Brexit considerations continue to affect various business lines for companies in the U.K. and in the mainland.

Asia Pacific

The impact of the coronavirus will be of particular focus across all of our Asia Pacific banks in the year ahead given its prevalence in the region. We will be particularly attuned to any pressure on bank revenue and asset quality on account of the virus' dampening effect on economic activity in affected areas.

In Japan, banks continue to face a difficult operating environment following a consumption tax increase in late 2019. Profitability will remain under pressure given negative interest rates from accommodative monetary policy, intense competition, and the country's aging and shrinking population.

For China, the majority of state-owned banks continue to report resilient earnings even in the face of a slowing economy and accelerating corporate defaults. Earnings have been supported by robust loan growth, strong fee income, and cost containment.

Singaporean banks remain fundamentally sound with ample loss absorption buffers. Record net profits in 2019 have added to the banks' fortress-like capital and have allowed for increases in dividends. Loan loss reserves are solid on the back of healthy asset quality, and liquidity and funding profiles are robust.

The creditworthiness of the major Australian banks is likely to remain sound in 2020. APRA, the Australian bank regulator, has been active in increasing capital and liquidity requirements, which has positioned the banks well against persistently low interest rates, muted loan demand, bushfire-related risks, and compliance/conduct issues.

Corporates

According to the Fed's financial stability report, the ratio of debt to assets for all publicly traded nonfinancial firms is at its highest level in 20 years. Fortunately, interest rates remain favorable such that debt service is manageable. While credit-rating upgrades exceeded downgrades during the year, the figures were near parity, with the downgrades driven by various idiosyncratic factors ranging from mergers and acquisitions and increasing leverage to sector slowdowns. In 2020, the coronavirus along with tariffs and trade deals have the potential to affect supply chains and end-markets, putting earnings growth at risk.

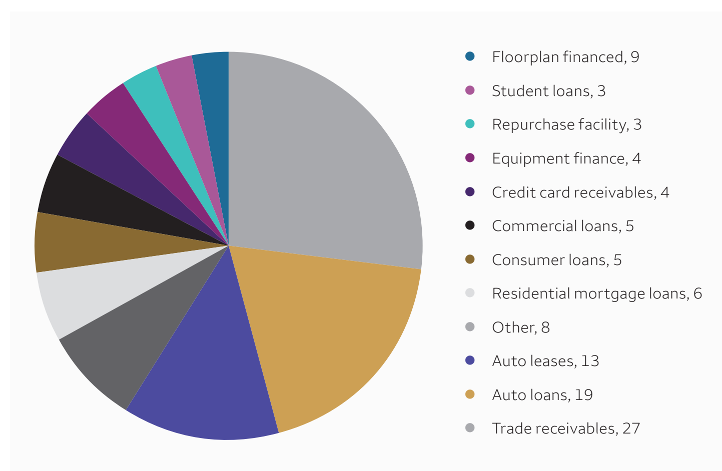
A heightened focus on ESG issues has put a spotlight on supply chains, inputs, and packaging, as well as the environmental impact of the manufacturing process. ESG-related downgrades for environmental and governance factors occurred both internally and at the rating agencies.

Structured finance

In the money market space, the level of asset-backed commercial paper (ABCP) outstanding remained range-bound for most of the year. However, with a strong fourth quarter, outstandings ended the year at $254 billion, up 0.5%. Following a typical seasonal pattern, some of the fourth-quarter growth was due to issuer warehousing in the front end as term securitization and other markets paused new issuance.

Collateral and structures remain robust in ABCP, and the sector saw a couple of new conduits come to market. In existing multi-seller platforms, asset growth was driven by traditional auto lines and trade receivables while newer categories, such as handset receivables, saw higher utilization. As shown below, the traditional asset classes of trade receivables, auto loans, and auto leases comprise the majority of assets in these structures.

ABCP asset types, by percentage, as of 9/30/2019



Sources: Moody's

ABCP ratings through the year were very stable, which is not surprising given they are tethered to the financial institutions providing their liquidity. The segment has shown continued stability in administrator depth, asset quality, and asset performance. As ESG themes weave their way through all sectors, we saw the first-ever green ABCP issuance in late 2019.

Further out the structured curve, asset-backed security (ABS) asset quality has remained stable, supported by continued low unemployment. Issuance volume was consistent with the prior year, with the bulk of issues originating in the auto, credit card, and equipment sectors. U.S. credit card issuers reduced issuance, with some of the volume picked up by issuers in other jurisdictions. Consumer loan and handset receivable ABS continue to see increased volume, while 2020 ABS issuance overall should come in similarly to 2019.

Total U.S. consumer debt balance and its composition, $ trillions

	Mortgage	HE revolving	Auto loan	Credit card	Student loan	Other	Total
Q4 2006	8.23	0.60	0.82	0.77	0.48	0.41	11.31
Q4 2010	8.45	0.67	0.71	0.73	0.81	0.34	11.71
Q4 2015	8.25	0.49	1.06	0.73	1.23	0.35	12.12
Q4 2019	9.56	0.39	1.33	0.93	1.51	0.43	14.15
Growth from Q4 2006	16%	-35%	62%	21%	213%	6%	25%

Sources: New York Fed Consumer Credit Panel and Equifax

Municipal sector

2019 remains a year of U.S. public finance upgrades

With continued U.S. economic expansion, we saw ratings strength across most municipal issuers in 2019. For instance, Moody's reported 148 upgrades versus just 78 downgrades in the third quarter.

At Standard & Poor's (S&P), upgrades fell and downgrades rose in the third quarter, but upgrades still surpassed downgrades by a ratio of 1.13 to 1 for the year (199 upgrades to 176 downgrades). S&P reports ratings movement for the year is positive despite the third quarter's lower upgrade-to-downgrade ratio.

In 2019, Fitch upgraded 144 ratings and downgraded 93, compared with 149 upgrades and 86 downgrades in 2018. Fitch reports that outlook trends for 2020 are mixed, with 93 positive rating outlooks versus 105 negative rating outlooks.

Outmigration

The U.S. continued to see trends in state-to-state migration in 2019, with more residents leaving the Northeast and Midwest for states in the South and Southwest. Approximately 40 million Americans relocate every year, representing 12% of the population. Leading causes for out migration include weather, tax rates, business costs, regulatory issues, and cost of living.

ESG

ESG is playing an ever-increasing role in municipal investment decision-making. Investors, including a number of states and cities, are leveraging their pension plans to press for change through sustainable investment. Issuers meanwhile have become more focused on the advantages of green bond issuance with ESG demand expected to support these financings over the long term.

2020 outlook

As we move into 2020, we continue to adapt and improve our credit processes by incorporating a deeper integration of ESG principles. As ever, we continue to monitor both issuer-specific and broader event risks and believe ESG will assist in framing our credit perspective.

At present, recent developments are top of mind, including the expected impact of the coronavirus on various economies, industries, and companies. Likewise, we continue to monitor potential policy changes related to the upcoming U.S. elections.

We will, of course, remain vigilant with respect to all credit issues in and beyond our investable universe. Indeed, while this has been one of the longest expansions in U.S. history, expansions eventually reverse, and our credit research and selection will be critical in weathering any associated downturn.

Rates for sample investment instruments—current month-end % (February 2020)

Sector	1 day	1 week	1 month	2 month	3 month	6 month	12 month
U.S. Treasury repos	1.59	1.59	–	–	–	–	–
Fed reverse repo rate	1.50	–	–	–	–	–	–
U.S. Treasury bills	–	–	1.41	1.35	1.25	1.13	1.00
Agency discount notes	1.42	1.44	1.43	1.35	1.29	1.17	0.91
LIBOR	1.57	1.57	1.52	1.50	1.46	1.40	1.38
Asset-backed commercial paper	1.57	1.58	1.50	1.57	1.47	1.53	–
Dealer commercial paper	1.59	1.57	1.60	1.50	1.44	1.26	–
Municipals	1.21	1.15	0.97	0.95	0.93	0.90	0.94

Sources: Bloomberg L.P. and Wells Capital Management

Wells Fargo Fund	7-day current yield
Cash Investment MMF*–Select	1.69%
Heritage MMF*–Select	1.70%
Municipal Cash Management MMF*–Inst'l	1.09%
Government MMF**–Select	1.53%
Treasury Plus MMF**–Select	1.52%
100% Treasury MMF**–Inst'l	1.42%

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 1.57%, 1.58%, 0.97%, 1.44%, 1.43%, and 1.38%, 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:

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1. The Bloomberg Barclays U.S. Corporate 1–5 Year Bond Index measures the investment-grade, fixed-rate, taxable corporate bond market. It includes U.S. -dollar-denominated securities publicly issued by the U.S. and non-U.S. industrial, utility, and financial issuers. You cannot invest directly in an index.

* *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.*

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** *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.*

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