Wells Fargo Money Market Funds

WELLS FARGO Asset Management


Contributing authors

Jeff L. Weaver
Head of Money Funds and Short Duration Strategies
415-396-4758
jeff.weaver@wellsfargo.com

Laurie R. White
Managing Director and Senior Fund Manager, Taxable Money Funds
612-667-4275
laurie.r.white@wellsfargo.com

Michael C. Bird
Senior Fund Manager, Taxable Money Funds
612-667-6529
michael.c.bird@wellsfargo.com

James C. Randazzo
Senior Fund Manager, Municipal Money Markets
704-374-3086
jrandazzo@wellsfargo.com

Madeleine M. Gish
Senior Fund Manager, Taxable Money Funds
415-396-2668
madeleine.gish@wellsfargo.com

John R. Kelly
Senior Fund Manager, Taxable Money Funds
612-667-2045
kellyjr@wellsfargo.com

Daniel J. Tronstad
Senior Fund Manager, Taxable Money Funds
612-667-7647
daniel.j.tronstad@wellsfargo.com

Kirstin A. Thomas
Senior Analyst, Money Market Credit
612-437-3609
kirstin.a.thomas@wellsfargo.com


PORTFOLIO MANAGER COMMENTARY

# Overview, strategy, and outlook

As of May 31, 2019

## Whither Brexit?

When we last discussed Brexit in our February commentary, the U.K. was facing a March 29 deadline for a hard exit from the European Union (EU) if the Parliament was unable to ratify the Withdrawal Agreement negotiated by Prime Minister Theresa May. After thrice failing in this endeavor, as well as in talks attempting to build a consensus, May was able to secure from the European Council an extension of the withdrawal date to October 31, 2019. With this much-needed breathing room, one would expect discussions and consensus-building to begin in earnest; alas, this was not to be. Rather than making progress toward a negotiated Brexit on the heels of March's near-miss, the various parties in government instead became more entrenched and inflexible. The standoff finally came to a head on the eve of the European Parliamentary elections. After 3 years of pleasing no one, surviving a no-confidence vote, and suffering an unprecedented 33 ministry resignations in opposition to her Withdrawal Agreement, Theresa May announced she would resign as head of the Conservative Party on June 7 and as prime minister when a successor is elected, the timing of which is likely to be later this summer.

The results of the EU Parliamentary elections were an indictment of the two major parties—the Conservatives and Labour—who both had abysmal showings. The paralysis of the mainstream political parties permitted the rise of a new party, the Brexit Party, led by Nigel Farage, formerly the head of UKIP (the U.K. Independence Party, a far-right, anti-Europe party). Although only six weeks old, the party came away with a substantial victory. Those voters in the Remainer camp flocked to the Liberal Democrats, who have staged a political comeback in the process. These results have pushed the Conservatives toward a harder Brexit, while Labour considers clawing back support by advocating remaining in the EU.

In our opinion, these developments have increased both the chances of a crash-out Brexit as well as a second referendum on the question of leaving the EU, while there no longer appears to be any chance of a smoothly negotiated Brexit. The Withdrawal Agreement between the EU and Theresa May's government will not come back for another vote in Parliament, and the EU has said emphatically the Withdrawal Agreement cannot be renegotiated.

In addition, the chances of a general election have also increased, which will be key to establishing which direction the U.K. goes, as it could change both the government and the composition of Parliament. And finally, although this option is a long shot, it is worth noting that the U.K. can still choose to revoke Article 50.

Consensus is that the new prime minister must deliver Brexit, but the question, though, is how this will be possible. In assessing the post-May landscape, our U.K. banking analyst probably summed it up best: "The side with the most stamina will probably win."

## Sector views

### U.S. government sector

Government money market yields fell in May because, much like the effects on a teenager hanging with the wrong crowd, all the influences were negative. First, on May 1, the Federal Reserve (Fed) made another technical adjustment to Interest on Excess Reserves, cutting the rate by 0.05% to try to nudge the federal funds effective rate back down near the middle of the Fed's target range. Although these technical adjustments are not meant to signal any intent about the future path of interest rates, they do have a real and pretty immediate impact on money market rates.

The second factor weighing on yields was the ongoing reduction of Treasury bill (T-bill) supply, continuing the usual seasonal contraction that follows the mid-April tax date. T-bill supply has fallen by $126 billion since then, with further reductions to come as the second quarter continues.

The last major influence on rates has been a robust Treasury market rally all along the curve, as the bond market continues to predict interest rate cuts by the Fed. This has affected the money markets in two ways. First, with cuts now expected by the market as soon as this year, money market rates have begun to reflect the anticipated lower rates. In addition to this direct effect, the fact that you have to go out about 20 years to find a Treasury security that can out-yield money market instruments has enticed some investors into the space, boosting demand and therefore pushing yields down. As an indication of the recent change in rates, the last 3- and 6-month T-bill auctions of April yielded 2.385% and 2.395%, respectively. By the time of May's last auctions, the same auction yields had fallen to 2.31% and 2.32%.

All these negative factors so far make 2019 the opposite of the halcyon days of 2018, when booming T-bill supply and a steadily hiking Fed helped yields march higher. Although the Fed professes patience on rates, surprises on the U.S. economy or any of a number of geopolitical issues could encourage it to move sooner than it intends.

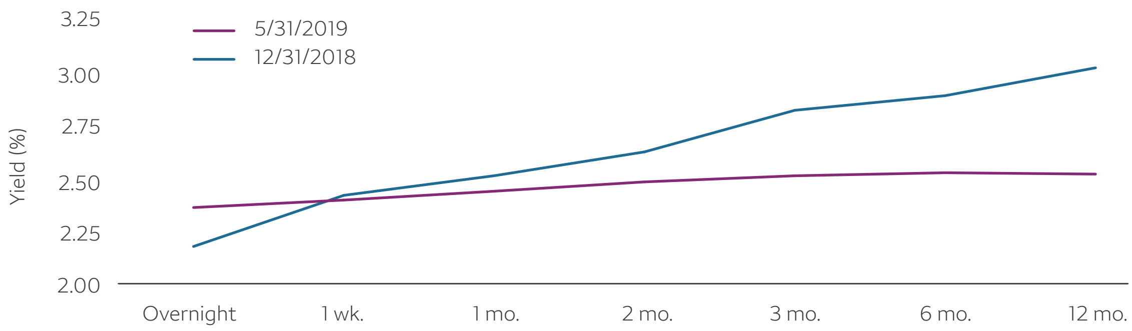
### Prime sector

The political landscape is putting the Federal Open Market Committee (FOMC) in a precarious situation: take no action, stay focused on actual economic data and risk losing market credibility, or cut rates and be perceived as caving to political or market pressures. Either way, the FOMC will have to communicate its intentions very clearly during upcoming speaking engagements and during the press conference at the conclusion of its June meeting.

The FOMC acknowledged at its May meeting that growth of household spending and business fixed investment slowed during the first quarter and that inflation is running below the 2% target. However, the FOMC reiterated the need for patience as sustained economic expansion and inflation nearing the 2% objective are the most likely outcomes. Subsequent economic data releases tend to support this idea as Personal Consumption Expenditures[1] ticked up to 1.6% year over year and the April change to nonfarm payrolls increased 263,000, helping lower the unemployment rate to 3.6%.

However, this month also brought additional uncertainties to future economic data as the once-encouraging trade discussions with China, Mexico, Japan, and Europe seemed to break down in various forms. Market participants are trying to get their arms around the potential negative economic impacts of trade and tariff wars on employment, business confidence, and inflation. As a result, the U.S. Treasury market saw a rally this month with a flight to quality as equities sold off. Yields on U.S. Treasuries two years and out fell 34 to 36 basis points (bps),[2] with 2-, 3-, and 5-year notes yielding less than 2% by month-end. The short end of the curve saw a decrease in yields as well, but not to the same extent since the target federal funds rate serves as a floor on rates. In the very front end, the 1-year London Interbank Offered Rate (LIBOR) is down about 21 bps this month and 3-month LIBOR fell just over 7 bps. The move rendered the LIBOR curve almost flat from three months at 2.50% to one year at 2.51%.

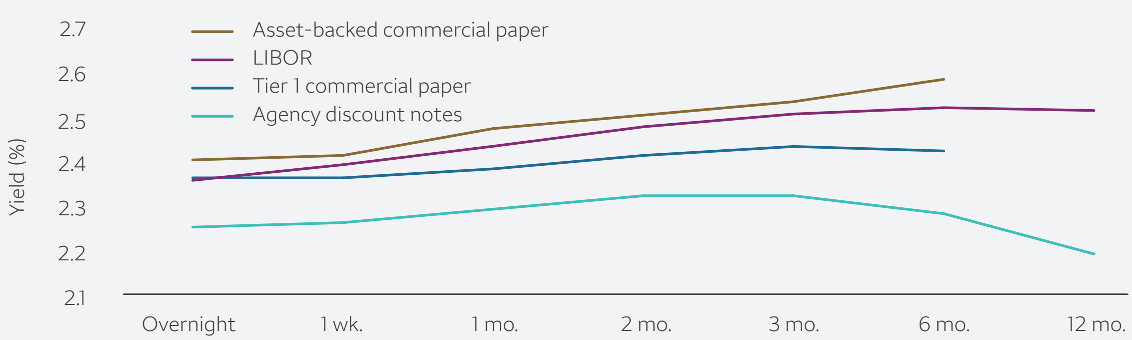
LIBOR yield curves




Source: Bloomberg L.P.

As you may recall, at year-end, the FOMC hiked rates 25 bps and said it needed to wait and see how the economy behaved before tightening again. As economic data comes in mixed, inflation remains soft and below the Fed's 2% target, and tariff talks heat up, market participants think the Fed's wait-and-see strategy doesn't include much waiting, and that we will see an ease, or perhaps two, before year-end. Currently, federal funds futures show more than a 70% chance of a 25-bp cut at the September FOMC meeting. This is reflected in the flatness of the LIBOR curve, with fixed-rate securities yielding 2.45% to 2.50% across the short-term curve. However, credit spreads in the money market space remained range-bound. The LIBOR-OIS[3] spread moved tighter by 1 bp in May to 17 bps. As a result, demand for floating-rate product continues to be strong as there is an incremental yield advantage over fixed-rate paper.

Money market yield curves, as of 5/31/2019




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

**Municipal sector**

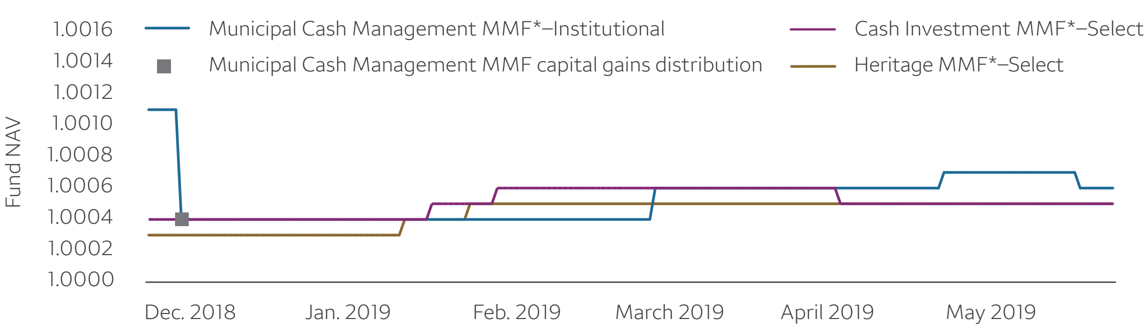
Following the dramatic spike in short-term rates during April, yields on daily and weekly variable-rate demand notes (VRDNs)[4] and tender option bonds (TOBs)[5] quickly began to normalize during the early part of May as opportunistic buyers quickly returned to the sector. The Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index,[6] which had reached a multi-year high of 2.30% (95% of 1-week LIBOR) in mid-April, quickly fell to 1.32% (55% of 1-week LIBOR) as municipal money market funds were the recipients of approximately $4.8 billion in assets during the first half of the month. The SIFMA Index would ultimately close out the month of May at 1.42%, as flows once again turned negative heading into month-end.

Further out on the curve, yields on high-grade commercial paper and notes also began to quickly normalize as levels on VRDNs and TOBs fell back down to Earth. Yields dropped roughly 30 bps to 40 bps to a range of 1.42% to 1.45% for one-month to three-month high-grade paper, respectively.

Meanwhile, yields on one-year high-grade paper continued to grind tighter, a general theme throughout the municipal market where supply and demand technicals have remained supportive of prices. Benchmark one-year levels fell to 1.49%, down from 1.68%, as the fixed-income markets have continued to more aggressively price in rate cuts by the FOMC in the second half of the year.

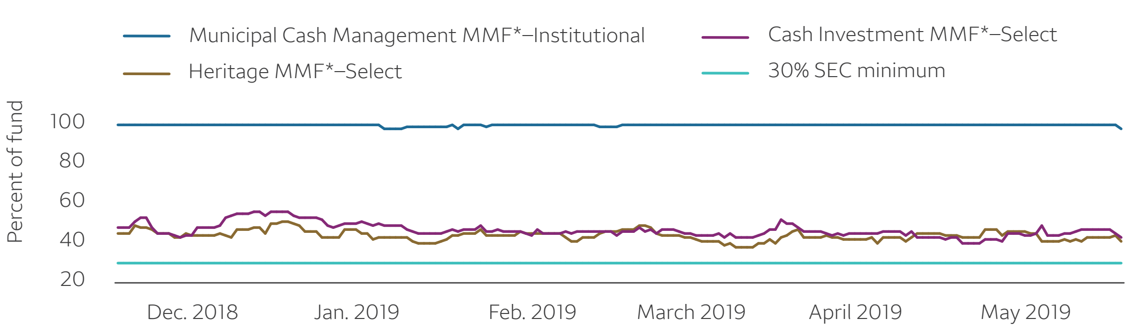
Despite the volatility in rates in the short end of the municipal money market space, our focus on variable-rate paper with daily and weekly puts helped us achieve our primary objectives of insulating our funds from price volatility and providing liquidity for our clients. Despite the volatility in floating rates throughout the year, the SIFMA to 1-week LIBOR ratio has averaged a healthy 68%, a level we deem attractive on a relative basis. We continue to feel that a focus on liquidity and principal preservation is prudent, particularly given the shape of the municipal money market yield curve and expectations for further volatility in the near term.

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




Source: Wells Fargo Funds

Wells Fargo FNAV money market fund weekly liquid assets




Source: Wells Fargo Funds

## On the horizon

Although we're still somewhat early in the process, discussions and events surrounding the debt ceiling may heat up along with summer temperatures. On May 22, Secretary of the Treasury Steve Mnuchin testified before the House Financial Services Committee and warned that the government may be in danger of default in "late summer." Accordingly, he urged Congress to increase the debt ceiling sooner rather than later—later being, presumably, when we're approaching the end of the usefulness of extraordinary measures in financing the government. In order to help facilitate this outcome, he and other Trump officials have begun discussions with congressional leaders on a two-year budget deal that would also raise the debt ceiling. While Mnuchin expressed confidence that Congress would raise the debt ceiling before a default would occur, the increasingly rancorous relationship between the executive branch and congressional Democrats seemingly points to a process that will be more, rather than less, protracted, and it would not be a surprising outcome to see a resolution to the debt ceiling pushed to the very last minute. When that minute occurs is still in question, but as we progress through the summer, the timing should become increasingly clear.

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

| Sector | 1 day | 1 week | 1 month | 2 month | 3 month | 6 month | 12 month |
|---|---|---|---|---|---|---|---|
| U.S. Treasury repos | 2.48 | 2.42 | – | – | – | – | – |
| Fed reverse repo rate | 2.25 | – | – | – | – | – | – |
| U.S. Treasury bills | – | – | 2.28 | 2.32 | 2.30 | 2.28 | 2.13 |
| Agency discount notes | 2.25 | 2.26 | 2.29 | 2.32 | 2.32 | 2.28 | 2.19 |
| LIBOR | 2.35 | 2.39 | 2.43 | 2.47 | 2.50 | 2.52 | 2.51 |
| Asset-backed commercial paper | 2.40 | 2.41 | 2.47 | 2.50 | 2.53 | 2.58 | – |
| Dealer commercial paper | 2.36 | 2.36 | 2.38 | 2.41 | 2.43 | 2.42 | – |
| Municipals | 2.25 | 1.42 | 1.42 | 1.44 | 1.45 | 1.47 | 1.49 |

Sources: Bloomberg L.P. and Wells Capital Management

| Wells Fargo Fund | 7-day current yield |
|---|---|
| Cash Investment MMF*–Select | 2.47 |
| Heritage MMF*–Select | 2.48 |
| Municipal Cash Management MMF*–Inst | 1.42 |
| | |
| Government MMF**–Select | 2.30 |
| Treasury Plus MMF**–Select | 2.29 |
| 100% Treasury MMF**–Inst | 2.22 |
| | |

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 reimbursements. Brokerage commissions, stamp duty fees, interest, taxes, acquired fund fees and expenses, and extraordinary expenses are excluded from the 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 2.36%, 2.38%, 1.31%, 2.23%, 2.21%, and 2.16%, respectively, and the total returns would have been lower. 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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*(Click "Select Your Role" in the top navigation and select "Institutional Cash Investor")*

1. The Personal Consumption Expenditures (PCE) Index 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 is part of the personal income report issued by the Bureau of Economic Analysis of the Department of Commerce. You cannot invest directly in an index.
2. 100 bps = 1.00%
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 LIBOR-OIS spread represents the difference between an interest rate with some credit risk built in and one that is virtually risk free.
4. 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.
5. A TOB is a type of VRDN where a long-term bond is placed into a trust. Floating-rate securities are created from the trust.
6. The 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.

**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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