WELLS FARGO Asset Management

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PORTFOLIO MANAGER COMMENTARY

Overview, strategy, and outlook

As of August 31, 2019

Money market overview

The fixed-income markets are convinced a recession is coming. Even as the U.S. economy continues to chug along, the markets have their eyes on the risks to the outlook. Having apparently set aside their rose-colored glasses, they see downside risks fully materializing, with some combination of gloom and doom resulting. The Federal Reserve (Fed) validated the market's concern with a 25-basis-point (bp)[1] rate cut at the end of July, and although it's unclear whether its actions will ultimately be characterized as a mid-cycle adjustment or a full-fledged easing cycle, it appears that at least one more rate cut is likely in the near future.

Resilient U.S. consumers, mostly employed and not shy about spending their paychecks, continue to buttress the economy. On the other hand, the manufacturing sector has been sluggish, and the question is whether that weakness eventually flows over to the consumer sector. The risks to the outlook, which include but are not limited to Brexit, slowdowns in Europe and China, and, most of all, trade wars and the uncertainty they fuel, have been driving the questions over manufacturing. If the bond market is correct and the U.S. economy slips into a recession, how will money market funds (MMFs) fare, especially prime funds, given the changed rules under which they've operated since the Securities and Exchange Commission's (SEC's) 2016 MMF reform? We examine their prospects below.

Sector views

Prime sector

While not all recessions are created equal, the most recent SEC rules implemented in 2016, acting in combination with the stringent regulations imposed on the banking sector after the financial crisis, have created an even more stable backdrop for MMFs than existed in the past. The new rules that came with the SEC's MMF revamp, discussed in greater detail below, are consistent with the conservative manner in which our funds have always been managed, emphasizing preservation of capital and high levels of liquidity.

Although the SEC has required prime funds to maintain minimum positions of daily and weekly liquid assets of 10% and 30%, respectively, since 2010, the 2016 reforms to SEC Rule 2a-7, which governs MMFs, went a few steps further by coupling those limits with liquidity fees and gates in the event of their breach. Those few additional steps prompted investor concern over the potential loss of liquidity from the imposition of fees and gates. To recap, the rules give fund boards the ability to impose a liquidity fee or redemption gate if a fund's weekly liquidity level drops below 30%. Probably in large part to avoid triggering such an event, fund managers have typically maintained weekly liquid asset levels well above the 30% threshold. In addition to adhering to regulatory requirements, we believe the most important aspect of liquidity management is understanding the liquidity needs of the different investors in the fund. We have long-established know-your-customer procedures that allow for ongoing and regular communication between the sales and investment teams. As a result, the portfolio management team is better able to understand the nature and timing of the fund's cash flows and manage the fund's liquidity accordingly.

The adoption of a floating net asset value (NAV) was also a significant concern for investors who were uncertain how much fluctuation they would see in their daily principal balance. We now have nearly three years of empirical evidence that shows institutional prime MMF NAV fluctuations have been minimal. The weekly liquid assets profile of a fund, as well as its holdings in floating-rate paper, can help decrease the NAV volatility that comes from the changing values of fixed-rate securities as interest rates change. During Fed tightening cycles, the higher rates cause the value of fixed-rate securities to decline, which puts downward pressure on funds' NAVs. Conversely, the lower rates during Fed easing cycles cause the prices of fixed-rate securities to rise, pressuring funds' NAVs higher. Funds with a high percentage of weekly liquid assets, as well as a significant allocation toward floating-rate securities, are said to possess a high degree of interest rate sensitivity. This causes the yields on those MMFs to adjust more quickly to changes in the interest rate environment and helps dampen the potential NAV effects caused by the Fed's actions.

In addition to adopting the 2016 changes imposing the floating NAV and the possibility of fees and gates, MMFs continue to be required to meet Rule 2a-7's guidelines surrounding credit diversification, maturity restrictions, and risk oversight, all of which shape a product that should better withstand exogenous events, including a recession. The rule's credit diversification requirements allow funds to invest in a wide range of credits but limit the exposure to any single issuer. The intent of this rule is to minimize the impact of any single credit on a well-diversified portfolio. In addition, we have a dedicated credit team that reviews each issuer to help ensure minimal credit risk is maintained. Our proprietary credit process and portfolio management tools used in concert can help us fine-tune the credit profiles of the funds and adjust them as conditions warrant.

Rule 2a-7's maturity restrictions serve to minimize the NAV impact of interest rate changes as shorter securities, those maturing sooner, have smaller price variations from a given interest rate move than longer securities, helping ensure a more stable product. Finally, our risk management team's stress tests of a MMF's ability to withstand certain hypothetical market stress events are an important tool used by portfolio managers. These hypothetical events include increases and decreases in short-term interest rates, downgrades or default of portfolio security positions, and a correlated increase in the credit spreads for certain portfolio securities, in combination with increases in shareholder redemptions. Results of these tests can help portfolio managers better manage risks in the portfolio and inform their investment decisions.

Having had an extended period to observe weekly liquidity levels in prime MMFs, investors appear to have become more comfortable with the ideas of a floating NAV and of fees and gates. Taken together, the demonstrated ample liquidity and relatively stable fund NAVs have encouraged investors to begin to move back into prime funds with at least a portion of their money market cash. As shown in the chart on the next page, prime assets have increased 87% since the 2016 SEC reforms and 26% since the beginning of 2019.

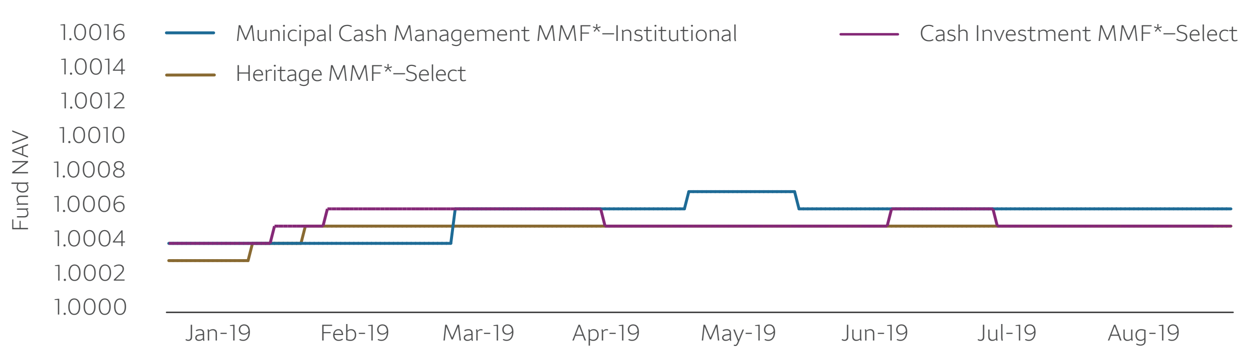
Prime money market assets ($ billions)

Source: Bloomberg

Aside from Rule 2a-7, the capital requirements imposed on the banking sector by Dodd-Frank and the increased amount of high-quality liquid assets banks are required to hold, in part to meet highly adverse stress test scenarios, are in place to minimize the impact of a recession or an unexpected event on banks and systemically important financial institutions. Apart from the obvious benefit to the economy of a stronger, more resilient banking sector, the more robust banking regulations are especially beneficial to prime MMFs as they enhance the credit profile of a large portion of the funds' underlying assets, those which are obligations in one way or another of banks. Over the prime MMF complex, holdings of a variety of security types issued by the finance sector represent 58% of fund assets. Additionally, repurchase agreements secured by government securities executed with bank counterparties, as well as direct investments in government securities, comprise another 28% of prime funds' holdings.[2]

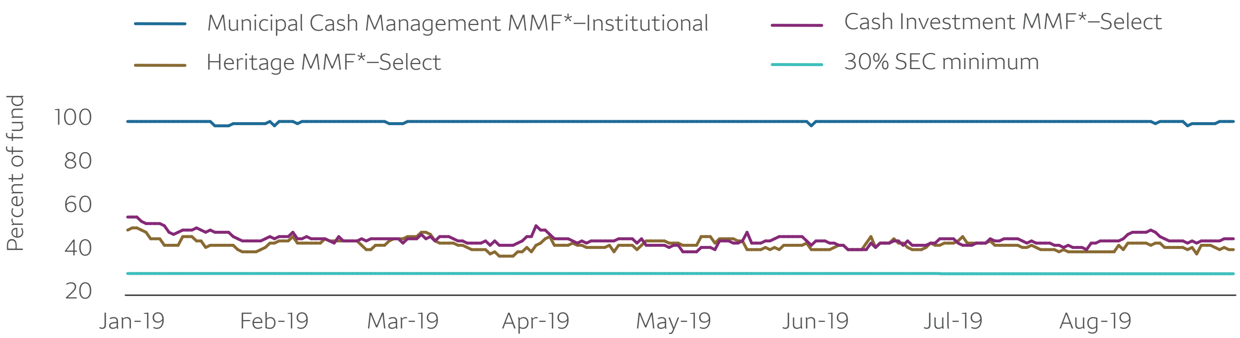
The liquidity, maturity, and diversification requirements mandated by the SEC have led to a more stable MMF product, especially in terms of liquidity and minimal NAV fluctuations, with an improved resilience in the face of market stresses. In addition, the bulk of the underlying holdings of the prime MMF sector are in securities issued by financial institutions, which have themselves been made more resilient by postcrisis regulations. If the economy does in fact slip into recession, the various changes to MMF and banking regulations have made MMFs better positioned to withstand economic stresses.

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

U.S. government sector

Quiet the summer was not. On the positive side, one of the risks to the outlook was resolved in late July when, with minimum drama, the debt ceiling was suspended for two years. By the time the agreement was reached, the U.S. Treasury's cash balance had fallen to $117 billion, about $200 billion below its average for the year. Free of the debt ceiling's shackles, the Treasury was able to begin boosting its Treasury bill (T-bill) issuance to rebuild its cash balance. While it was constrained by the debt ceiling from April through July, total T-bill supply fell by $269 billion. In August, supply grew by $121 billion, with more to come over the balance of the year.

Other things to appreciate this summer were the resilience of the U.S. economy, which has yet to catch a cold from the trade-driven global weakness, and the weather. That's about it.

Although U.S. equities managed to reach new heights during the summer before giving up some of those gains, they've been nervous and volatile, despite having generally not yet followed the bond markets' robust embrace of the downside risks. A good summary of those risks was presented by Fed Chair Powell in his August 23 speech in Jackson Hole, Wyoming:

> "The three weeks since our July FOMC meeting have been eventful, beginning with the announcement of new tariffs on imports from China. We have seen further evidence of a global slowdown, notably in Germany and China. Geopolitical events have been much in the news, including the growing possibility of a hard Brexit, rising tensions in Hong Kong, and the dissolution of the Italian government."

To get ahead of the impact any of those risks may ultimately have on the U.S. economy, the Fed cut rates in July by 25 bps, with another cut likely at its mid-September meeting. Further policy easing is possible and will likely depend on the evolution of the various risks.

Besides the challenges of divining the future, Mr. Powell faces other difficulties. The first is that, based on details presented in recent meeting minutes and in public statements, the Federal Open Market Committee (FOMC) seems unusually divided between hawks impressed with the economy's resilience and doves worried about future risks. The differences have appeared in policy votes at the past two meetings, with a dovish dissenter in June who would have preferred to cut rates rather than stay on hold and two hawkish dissenters in July who would rather have stood pat than eased.

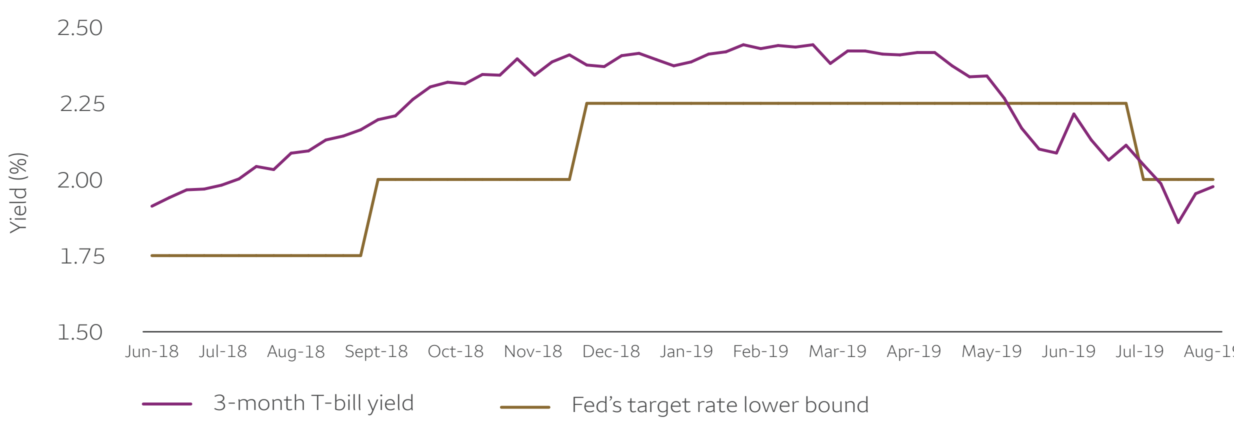
A second twist is that he faces political pressure that was heretofore unimaginable. While the permanence of his appointment seems well-established in the law, and harsh words therefore have little impact—like water off a duck's back—it's still rather remarkable to see a Fed chair labeled an enemy by the U.S. president, as he was in a tweet following the Jackson Hole speech:

> "... My only question is, who is our bigger enemy, Jay Powell or Chairman Xi?"

In the end, Mr. Powell will have no choice but to deal with a divided committee (an old problem) and overt political pressure (a new one and a sign of the times) as he and the FOMC try to guide the economy through the current slowdown without impairing the Fed's independence. No one ever said the job was easy.

As for how the government money markets have taken all this, the T-bill market has seen an only occasionally relenting bid, pushing yields consistently lower week after week, as shown in the chart below comparing T-bill yields with the bottom of the Fed's target range. The T-bill market generally has two main drivers: the expectation of the Fed's future interest rate path and the supply and demand balance, which is largely driven by the U.S. Treasury's needs. At times, these influences are in opposition, while at other times, they're in sync. For instance, for much of 2017 and 2018 they acted together to push yields higher, as the Fed was raising rates at the same time the U.S. embraced higher government deficits, which needed to be funded with greater Treasury issuance. If those years were, for investors, the best of times, then the summer of 2019 was the worst of times, at least as far as T-bill market influences go. With T-bill issuance constrained by the debt ceiling at the same time the Fed shifted into easing mode, all yield signs pointed south. Now, as we head into fall, the influences look to pull against each other, with the Fed's interest rate cuts being at least somewhat tempered by the higher T-bill supply expected as the Treasury rebuilds its cash balance after the debt ceiling resolution. Make no mistake, if the Fed cuts interest rates, T-bill yields will decline, but perhaps not as aggressively as they did over the summer.

3-month T-bill yield vs. Fed's lower bound



Source: Bloomberg

Municipal sector

Yields in the municipal money market space remained inverted throughout the month of August as rates on overnight and weekly variable-rate demand notes (VRDNs)[3] and tender option bonds (TOBs)[4] continued to outpace the longer end of the curve. Despite the elevated levels in the short end, the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index[5] remained range-bound before closing out August at 1.35%, down from 1.40% the previous month. Moderate outflows from municipal MMFs continued to contribute to weakness in demand in the short end as remarketing agents have remained defensive in setting rates to attract the attention of less dependable buyers such as separately managed accounts and bond funds.

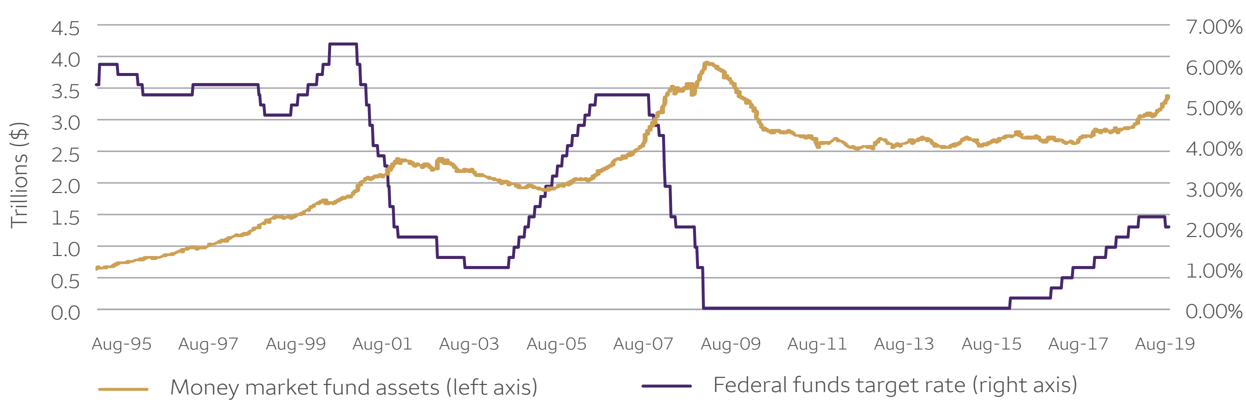
Further out on the curve, yields on high-grade fixed-rate paper in one-month to six-month maturities tightened roughly 5 bps to 10 bps to the 1.20% to 1.25% area. In the one-year space, the state of Texas issued $8 billion in tax and revenue anticipation notes with yields ranging from 1.25% to 1.32%. The largest note deal of the year attracted strong interest beyond traditional MMFs with yields comparable to 10-year high-grade municipals. The Texas deal was met with voracious demand from investors outside of the 2a-7 space due to record-setting inflows into municipal bond funds, according to Lipper, along with the broad rally in the fixed-income markets.

During the month, we continued to emphasize principal preservation and liquidity by targeting our purchases on VRDNs and TOBs with daily and weekly puts. The inverted yield curve in the municipal space has allowed us to enjoy the benefits of higher short-term rates without the need to extend the weighted average maturity of our portfolios. Despite the volatility that can be experienced in the SIFMA Index, we continue to feel that this sector of the curve offers attractive nominal and after-tax returns for municipal investors, particularly as the municipal yield curve has remained relatively flat to inverted.

On the horizon

We addressed above the potential for an economic recession and the related move by the Fed to begin lowering interest rates, which together beg the question of how investors have viewed MMFs as cycles have turned. As shown below, it turns out that MMFs have continued to gather assets whether the Fed was raising or lowering rates through all the cycles since 1995. MMF balances have seen modest declines only after the Fed has stopped cutting, when investors see low rates sticking for a while. Based on this solid long-term pattern of behavior, we anticipate that MMFs' unique characteristics will continue to appeal to investors during future Fed cycles.

Federal funds target rate and money market fund assets



Source: Bloomberg L.P.

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

Sector	1 day	1 week	1 month	2 month	3 month	6 month	12 month
U.S. Treasury repos	2.15	2.17	–	–	–	–	–
Fed reverse repo rate	2.00	–	–	–	–	–	–
U.S. Treasury bills	–	–	2.05	1.98	1.93	1.83	1.71
Agency discount notes	1.97	1.98	1.98	1.94	1.87	1.67	1.70
LIBOR	2.09	2.14	2.09	2.15	2.14	2.04	1.97
Asset-backed commercial paper	2.14	2.14	2.13	2.11	2.10	2.01	–
Dealer commercial paper	2.13	2.11	2.08	2.03	1.99	1.95	–
Municipals	1.39	1.35	1.22	1.21	1.20	1.15	1.16

Sources: Bloomberg L.P. and Wells Capital Management

Wells Fargo Fund	7-day current yield
Cash Investment MMF*–Select	2.19
Heritage MMF*–Select	2.20
Municipal Cash Management MMF*–Inst'l	1.32
Government MMF**–Select	2.03
Treasury Plus MMF**–Select	2.00
100% Treasury MMF**–Inst'l	1.91

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 (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 2.08%, 2.11%, 1.21%, 1.96%, 1.92%, and 1.88%, 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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Website: **wfam.com**

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1. 100 bps = 1.00%
2. SEC.gov, Money Market Fund Statistics, Form N-MFP Data, period ending July 31, 2019.
3. 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.
4. 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.
5. 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.