WELLS FARGO ASSET MANAGEMENT

Portfolio Manager Commentary

Overview, strategy, and outlook: As of March 31, 2017

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Money market sector views

Prime sector

At the beginning of 2017, the market's base case was for the Federal Open Market Committee (FOMC) to raise its target rate twice this year, with most participants thinking rate hikes would occur in June and December. Even as economic data continued its improving trend and inflation indicators started to tick up, market expectations were tempered by the considerable uncertainties surrounding the new administration's impacts on growth and inflation. This wait-and-see attitude taken by the FOMC resulted in the market assigning a roughly 35% chance of a Federal Reserve (Fed) rate hike at its March 15 meeting as late as two weeks prior to the meeting. Fed speakers had to quickly adjust market expectations to accommodate economic reality, with William Dudley at a speech[1] on February 28 saying:

"… I think the case for monetary policy tightening has become a lot more compelling."

His position was reinforced by Chair Yellen a few days later[2]:

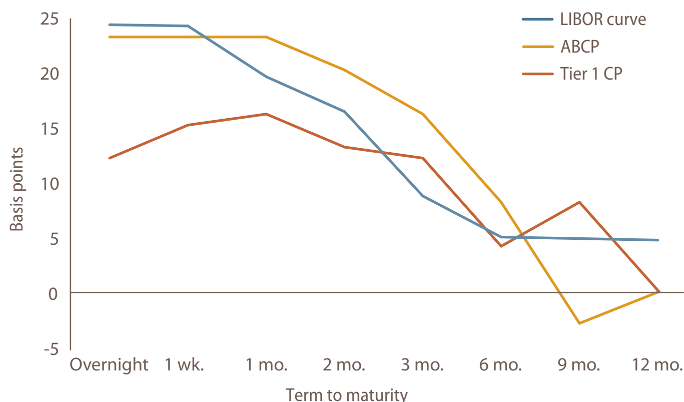
"At our meeting later this month, the committee will evaluate whether employment and inflation are continuing to evolve in line with our expectations, in which case a further adjustment of the federal funds rate would likely be appropriate."

Once Dudley spoke, market expectations adjusted fairly quickly and the probability of a March rate hike jumped to almost 100%. As expected and signaled, the Fed raised the target rate to the range of 0.75% to 1.00% at its March meeting. The meeting also included an update to its Summary of Economic Projections (the Dot Plot), which showed very little change in outlook, essentially signaling that the economy was evolving as expected. In summary, inflation was headed in the right direction, although core readings were generally stable, thereby indicating a lack of urgency on the Fed's part. In framing the path of future rate hikes, as long as supportive financial conditions continue and data evolves as expected, the Fed should move along its prescribed path, which remains accommodative and gradual. It did add the term *symmetrical* to its inflation discussion, hinting that inflation can run hot before the FOMC feels compelled to change its outlook. The Dot Plot also suggests two additional hikes in 2017 and three in 2018.

Before the expectation reset on February 28, three-month LIBOR (London Interbank Offered Rate) had increased during the month from 1.03% to 1.05%; after it became apparent a rate hike was imminent, three-month LIBOR rose to 1.10%; and after the hike occurred, three-month LIBOR reset at 1.15%—not fully reflecting the 25-basis-point (bp; 100 bps equals 1.00%) move. That muted reaction—representing about half the Fed move—also was reflected in the commercial paper (CP) market but to an even greater degree. For example, three-month dealer-placed AA financial yields initially spiked to 1.05% after the tightening; however, the yield drifted lower in the days

following. Why such a muted response in both LIBOR and CP yields? Part of the answer probably lies in recently enacted regulations, which have made short-term borrowing costly to bank borrowers and pushed them out to the long end of the very short end of the yield curve. With money market reform in the fall of 2016 and the loss of assets in the prime sector, issuers also have had to turn to alternative avenues of funding—such as deposits and repurchase agreements (repos)—to meet their funding needs. Because there is less dependence on short-term borrowing and fewer assets in the sector, both CP yields and LIBOR are slower to react to changes in the target rates. This has been evident in the three-month and shorter part of the money market curve where some corporate borrowers have been executing trades at lower yields than the LIBOR benchmarks traditionally would suggest.

LIBOR and CP yield changes, 2-28-17 to 3-31-17



Source: Bloomberg L.P.

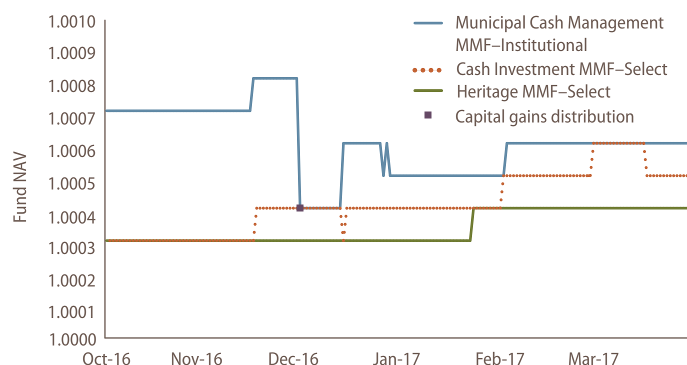
ABCP = Asset-backed commercial paper

Past performance is no guarantee of future results.

As these divergences between LIBOR and bank funding levels have become more pronounced, the subject of reforming how the benchmarks are derived has come to the fore. Both the Alternative Reference Rates Committee (ARRC) and the Intercontinental Exchange (ICE) are discussing ways to improve interest-rate benchmarks and reduce the systemic risk associated with them. Neither organization contemplates an end to LIBOR; however, ARRC, in particular, would like to see a significant portion of derivatives that reference LIBOR move to a more robust alternative rate. That might be the unsecured Overnight Bank Funding Rate or a secured index tied to general collateral Treasury repo rates. On the other hand, ICE would like to change the method of rate-setting by relying first on actual funding transaction yields, then on levels derived from transactions, and finally on "expert judgment, appropriately framed." But without a doubt, as markets continue to settle into a postreform environment, we are likely to hear more about this topic.[3]

With the Fed in play and the future path of interest rates evolving, the yield spread is widening between government funds and prime funds—certainly a different experience from the past eight years of interest rates basically at zero. This has not, however, prompted a change in our strategy. We continue to manage our prime funds with the same conservative discipline as before reforms, adhering to a philosophy of constructing a diversified portfolio of high-quality, liquid assets to meet our clients' liquidity needs while offering an attractive risk-adjusted yield. This management style also meets our objective of preservation of principal, with our net asset value (NAV) volatility remaining negligible even as the interest-rate landscape changes.

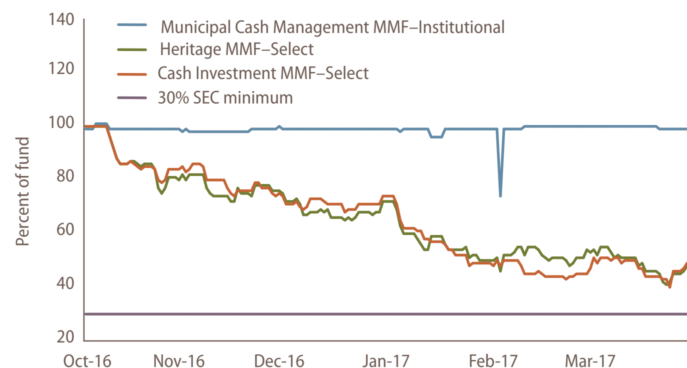
Wells Fargo FNAV money market fund NAVs



Source: Wells Fargo Funds

Past performance is no guarantee of future results.

Wells Fargo FNAV money market fund weekly liquid assets



Source: Wells Fargo Funds

Past performance is no guarantee of future results.

U.S. government sector

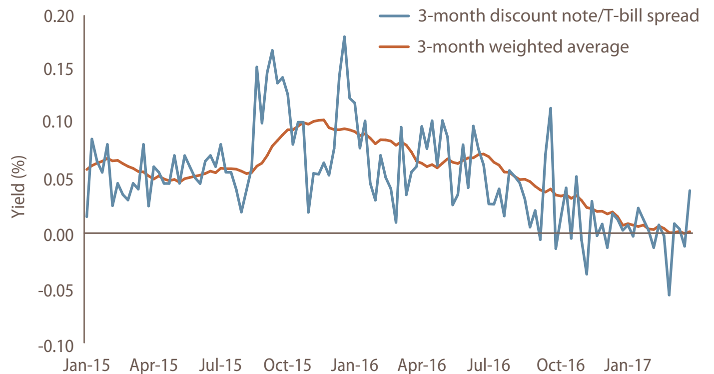
With the sometimes unwelcome help of the regulatory effort to remake the money markets, the government sector has evolved to the point where formerly momentous events in March passed relatively uneventfully. And March experienced not one but two potentially destabilizing events. While the first was the almost-surprising rate hike, the other big event

was the debt ceiling–driven contraction in Treasury bill (T-bill) supply, which coincidentally culminated on exactly the same day the Fed raised interest rates: March 15. From a peak of $1.870 trillion in late November 2016, total T-bills outstanding ground lower by $218 billion to $1.652 trillion on March 15. The supply rebound began the very next day, as the Treasury opened up room under the debt ceiling to issue additional T-bills by beginning to employ its typical-for-this-circumstance extraordinary measures. For the record, the United States' statutory debt limit was increased on March 16 to $19,808,772,381,624.74, which is probably the last time you'll see it below $20 trillion. As for the ongoing impact of the debt ceiling, as we discussed last month, the Treasury can operate in a business-as-usual mode throughout the summer until it exhausts those space-creating measures sometime in the fall.

The more interesting development regarding the debt ceiling during March was an increased risk of having another OK Corral–type showdown to actually get the debt ceiling raised or suspended later in the year. The market's base case since November has been to rely on the single-party control of Congress and the presidency leading to a calm debt-ceiling resolution. The March legislative stumble on health care, with the more conservative Freedom Caucus reluctant to move to the center to join the bulk of the House Republicans, raises the specter of similar ideological battles down the line. The odds of a happy ending continue to be higher than if the government was divided between the major parties, but they have come down.

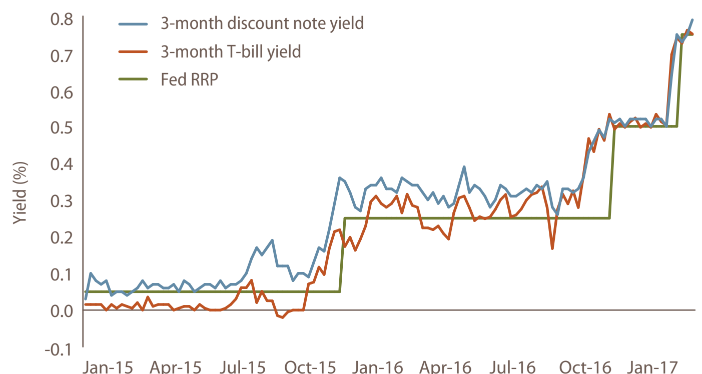
As mentioned above, the market dealt with a near-surprise Fed hike and oscillating T-bill supply with hardly a hiccup, and it's largely due to two particular aspects of the evolved structure of the government money markets. The first is the Fed's reverse repurchase program (RRP), a product of its large balance sheet resulting from the quantitative easing (QE) programs it used during and after the financial crisis to boost the economy. With a practically unlimited amount of securities on hand to collateralize borrowing—trillions of dollars' worth—the RRP has been quite effective at setting a floor on interest rates. The second feature is the vast expansion in assets in government money market funds (MMFs) driven by the MMF regulatory change that took effect last October. Again, the numbers are big. What was a $969 billion complex (combined government and Treasury funds) in October 2015 is now a $2.083 trillion behemoth. That's a lot of money that can buy only a very particular kind of asset—U.S. government securities—and investors, desiring to earn more than the floor, aggressively pursue securities providing that edge. You're left with two very large opposing market forces, which have tended to reduce market volatility. The spread of the yields on agencies over Treasuries has largely disappeared, as shown in the first chart on this page, and agency and Treasury yields basically have converged around the RRP yield, particularly since MMF reform concluded late in 2016, as shown in the second chart.

3-month discount note/T-bill yield spread



Source: Bloomberg L.P.
Past performance is no guarantee of future results.

Government security 3-month yields



Sources: Bloomberg L.P. and U.S. Treasury
Past performance is no guarantee of future results.

These two forces, vast money that must be invested colliding with an equally large sum acting as a bulwark under the floor, have tended to minimize the impact of smaller market fluctuations, such as the recent T-bill supply gyrations. What could overcome the Godzilla versus King Kong stalemate? The president seems unworried about debt and deficits, and it seems possible the government could embark on new deficit-financed spending. After all, the president seems keen to keep his promises, some of which are expensive, and balancing the budget wasn't one of his headline issues. Funding this in part by issuing T-bills could move yields off the floor. Another potential scenario would see the Fed ceasing to reinvest its QE-acquired investment portfolio maturities. If this played out to its ultimate conclusion, the Treasury likely would issue more bills to the public to replace issuance to the Fed, and the Fed's RRP would necessarily shrink as it would no longer hold the underlying assets. We'll discuss the Fed's reinvestments in a future commentary.

Municipal sector

It took some time but the municipal money market eventually responded with higher benchmark yields following the Fed's interest-rate policy move on March 15. Although the taxable markets already had begun to gradually price in a rate hike in advance of the FOMC meeting, the tax-exempt markets followed its usual wait-and-see path. The net result was that tax-exempt yields began to underperform relative to taxable equivalents, particularly in the overnight and weekly variable-rate demand note (VRDN) and tender option bond (TOB) sectors. Following the Fed move, the tax-exempt space was forced to play catch-up and responded quickly with rapidly rising interest rates on the short end of the curve. The Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index,[4] which had lingered at a year-to-date low of 0.62% prior to the FOMC meeting, quickly began to ratchet higher through the remainder of the month. The index ultimately would rise to a multiyear high of 0.91% at month-end, firmly reestablishing itself at an attractive 95% ratio to one-week LIBOR in order to attract the support of marginal crossover buyers.

While the short end of the curve was relatively quick to respond to rising general market yields, the reaction at the long end was muted. The municipal money market yield curve actually became inverted as yields on high-grade one-year paper increased only roughly 5 bps to the 0.86% level. During the month, we continued to maximize our exposures in the short end of the curve by limiting our purchases to VRDNs and TOBs with daily and weekly puts. This allowed us to quickly capture higher market-level yields while maintaining an emphasis on liquidity and principal preservation. Our belief that supply and demand dynamics will continue to result in relatively attractive tax-exempt to taxable ratios in the overnight and weekly sectors is unwavering; in addition, the upcoming seasonal tax-payment weakness also should put upward pressure on tax-exempt levels and ratios in the near term.

On the horizon

Without the prospect of impending reform, we anticipate April should be a fairly quiet month for the money markets—unlike last year. About the only notable event on the horizon is tax day on April 18. If this year is like normal years, we should expect some volatility in the markets around that date as balances in MMFs build prior to the deadline and then decline shortly after the deadline as corporations and individuals make their payments. Ultimately, the sum total of money market assets at the end of April is likely to be lower than at the beginning of April, which may help push the overall level of interest rates marginally higher. But all this should be the result of supply and demand dynamics and not due to regulatory or legislative actions—a welcome change, indeed.

Rates for sample investment instruments — current month-end % (March 2017)

Sector	1 day	1 week	1 month	2 month	3 month	6 month	12 month
U.S. Treasury repos	0.80	0.81	–	–	–	–	–
Fed reverse repo rate	0.75	–	–	–	–	–	–
U.S. Treasury bills	–	–	0.73	0.71	0.75	0.90	1.00
Agency discount notes	0.56	0.59	0.69	0.76	0.79	0.83	0.98
LIBOR	0.92	0.95	0.98	1.03	1.15	1.42	1.80
Asset-backed commercial paper	0.94	0.95	1.00	1.07	1.15	1.43	–
Dealer commercial paper	0.75	0.78	0.82	0.87	0.96	1.12	–
Municipals	0.96	0.91	0.93	0.95	0.97	0.99	0.86

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

Wells Fargo Fund	1-day yield	7-day current yield
Cash Investment MMF–Select	0.97	0.96
Heritage MMF–Select	0.96	0.95
Municipal Cash Mgmt MMF–Inst'l	0.79	0.73
Government MMF–Select	0.64	0.63
Treasury Plus MMF–Inst'l	0.59	0.58
100% Treasury MMF–Inst'l	0.52	0.50

Source: Wells Fargo Funds
Past performance is no guarantee of future results.

Does not include sales charges and assumes reinvestment of dividends and capital gains.

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 0.84%, 0.79%, 0.64%, 0.55%, 0.55%, and 0.30%, 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 or the total annual fund operating expense after fee waivers, as stated in the prospectus.

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1. Source: http://money.cnn.com/2017/02/28/news/economy/new-york-fed-dudley-interview-transcript/
2. Source: https://www.bloomberg.com/news/articles/2017-03-03/fed-chair-yellen-s-executives-club-of-chicago-remarks-text
3. Source: JP Morgan U.S. Fixed Income Markets Short Duration Strategy Weekly. Authors were Alex Roever, Teresa C. Ho, and John R. Iborg.
4. 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.

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