Portfolio Manager Commentary

Overview, strategy, and outlook: As of March 31, 2018

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Money market overview

While the peaceful transition of power at the Federal Reserve (Fed) occurred on February 1, late February and early March gave the markets the first taste of policy under new Fed Chair Jerome Powell. His semi-annual testimony to Congress on February 27 and March 1 contained few surprises for observers and seemed to stress continuity from the Yellen regime. During his testimony, he noted that his task was to balance the prospect of rising rates of inflation with anticipated economic growth spurred on by tax cuts and stimulative fiscal policy, and he stressed that the future path of interest rates would remain dependent on economic data. While this reassured many market observers that policy would continue as it had under the previous chair, other strategists seized on his observation that the economy had improved recently and concluded that this Fed may tilt slightly more hawkish on rates; this, in turn, buoyed hopes among some that not three but four rate increases could be in the cards for the year. So with a March tightening a virtual certainty, all anticipation focused on the release of the updated Summary of Economic Projections (SEP).

Sector views

Prime sector

March came in like a lion as the Federal Open Market Committee (FOMC) delivered a much anticipated rate hike at its March 21 meeting, raising its target rate 25 basis points (bps; 100 bps equal 1.00%) and moving the target funds rate to a range between 1.50% and 1.75%. This rate increase marks the sixth 25-bp increase since the Fed started the hiking process in late 2015. The corresponding statement reflected the FOMC view that the economic outlook has strengthened in recent months, paving the way for additional rate hikes.

The FOMC also updated its SEP in which the median dot plots affirmed the view that the target rate would increase at least three times in 2018 and maintained the median longer-term view of its terminal target rate of 2.90%. However, the median target rate dots adjusted higher to three 25-bp hikes in 2019 and an additional two 25-bp hikes in 2020. Interestingly, though, especially for market hawks, while the 2018 median rate forecast between December and March was unchanged with three increases, the composition of the dots seemed to give a slightly more hawkish tilt to the forecast, with a fourth increase in 2018 not out of the question.

On the economic front, the FOMC's growth assessment in 2018 and 2019 was upgraded in anticipation of expanded economic activity driven by fiscal stimulus. Gross domestic product (GDP) expectations for 2018 were raised to

2.7% from the 2.5% expected in December, while 2019 expectations were upgraded to 2.4% from 2.1%. These gains are expected to drive the unemployment rate lower this year and next, establishing a full employment at a forecasted 3.6% unemployment rate in 2019. In addition, stronger growth and continued strength in the jobs market are not expected to push inflation significantly higher.

Even as the FOMC confirmed market expectations for a steeper path for future rates, the London Interbank Offered Rate and Overnight Index Swap (LIBOR-OIS) rate spread widened to levels not seen since 2016, indicating possible stresses in the money markets. The LIBOR-OIS spread is the difference between LIBOR and the OIS rate. It represents the difference between an interest rate with some credit risk built in (LIBOR) and one that is relatively risk free (OIS) over a certain time period and reflects not only credit risk but also term premiums. Typically the LIBOR-OIS spread widens as a result of credit stresses in the banking sector or a decline in demand from investors. For example, in 2008, this spread widened to 3.64 (3.64% or 364 bps) on October 10 as the full impact of the deterioration of creditworthiness hit the financial markets in the wake of Lehman Brothers' bankruptcy on September 15 (designated by the red star in the 2008 chart below).

2008 LIBOR-OIS spread

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

However, the spread widening to 0.44 in the fall of 2016 was technical in nature as a structural shift in demand resulted when assets moved from prime money market funds to government funds during the implementation of the SEC's money market reform. As you may recall, this asset shift began in earnest during the third quarter of 2016 in advance of the October 13 implementation deadline. This shift in assets caused banks to compete to obtain unsecured funding from a smaller base of investors, causing yields and LIBOR to increase.

2016 LIBOR-OIS spread

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

The current LIBOR-OIS spread widening likely is due to a smorgasbord of supply/demand reasons and not due to credit stress. On the supply side, we see elevated Treasury bill (T-bill) and repo supply (discussed in greater detail in the government section) and an increase in the amount of commercial paper outstanding. On the demand side, yields are being influenced by the reduction of excess reserves, a decline in prime fund assets during the first quarter, and reduced demand from other short-term investors—likely a result of tax reform and possibly repatriation effects. This combined increase in supply and reduction in demand is causing unsecured bank funding levels to rise. In fact, March is going out like a lion, too, with no abatement to the widening: LIBOR-OIS spreads started March at 0.41, close to the reform-related wides, and ended March at 0.59 with the pace of increase slowing toward month-end.

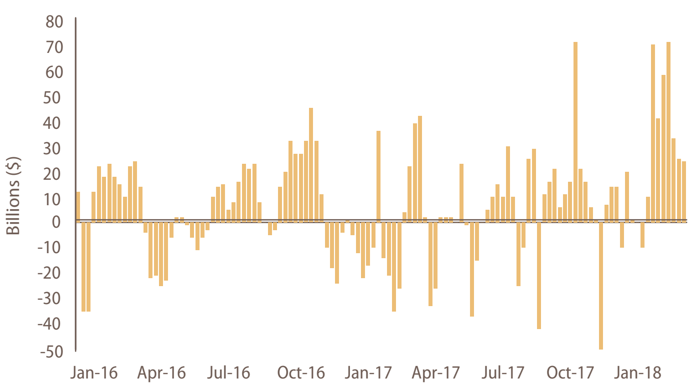
Our funds' profiles continue to emphasize higher levels of liquidity and shorter maturities, with our weighted average maturities hovering at about 8 to 10 days shorter than the industry average. Toward the end of the month, as the rate of increase in LIBOR and spreads slowed, we were able to add floating-rate note product to the prime portfolios, and our profile affords us the flexibility to add longer-dated product as opportunities arise in the future.

U.S. government sector

The story dominating the government money markets in March was the well-telegraphed, but still disruptive, burst of T-bill issuance, which has pushed yields higher across the money markets and left private borrowers scrambling to compete with the big government borrower. This is a mirror image of the government's impact on supply and demand during the postcrisis period, when the government, wearing its Fed robes, had excess money and competed with lenders on the demand side. Now the Fed has stepped away as a buyer, weakening demand just as the Treasury has an enormous appetite for money.

The supply stars began to line up in December 2017, when the federal government enacted a new tax law, pointing to higher federal deficits and therefore greater borrowing needs. However, because the Treasury was constrained by the debt ceiling at that time, real net new borrowing was delayed until the debt ceiling was suspended in February. The real kicker for supply, though, was the budget bill that accompanied the debt ceiling resolution, promising more spending; greater deficits; and more debt issuance to pay for it all. As shown in the chart below, net weekly changes in T-bill supply over the past several years has fluctuated with the Treasury's seasonal cash needs, but the latest issuance surge is unmatched in recent years. Since the first week of February when the Treasury shed its debt ceiling shackles, total T-bills outstanding have risen $332 billion.

Weekly net new T-bill issuance

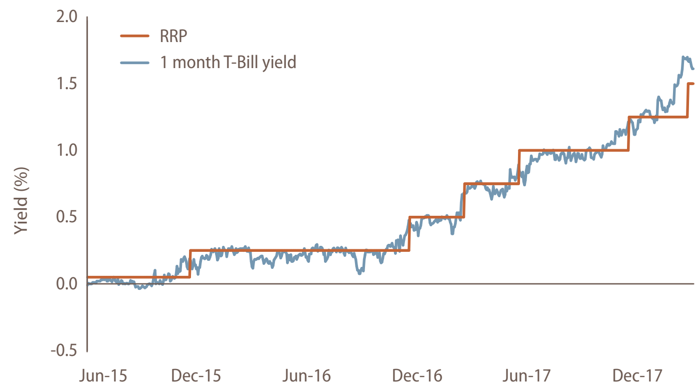


Source: U.S. Treasury

The surge in T-bill supply has affected the markets in a number of ways. First, most obviously, T-bill yields have risen. As shown in the top chart at right, 1-month T-bill yields generally have traveled just below the rate on the Fed's reverse repo program (RRP), which itself is intended to mark the lower end of the Fed's overnight interest rate range. Whenever a Fed rate hike appeared imminent, T-bill yields would price the hike in and nudge above the line, only to settle in again shortly after the rate hike had passed. Yields in the past several months have strayed from that behavior, trading noticeably higher than the RRP rate.

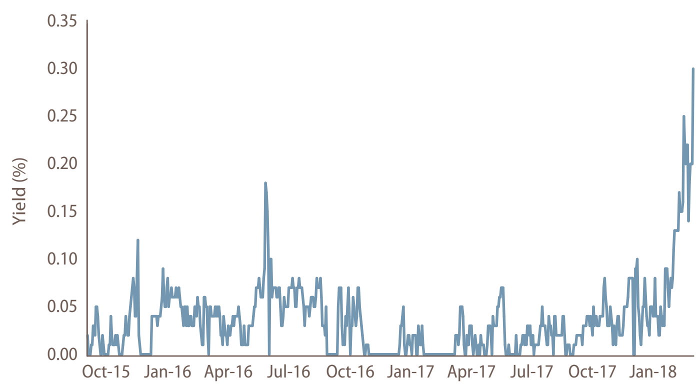
The additional T-bills in the system also need to be financed while they reside on dealer balance sheets, and this has pushed repo rates higher. The bottom chart at right shows the degree to which repo rates, as measured by the BNY Mellon Treasury Tri-Party Repo Index, have exceeded the RRP rate.

1-month T-bill yields and RRP



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

Excess of tri-party repo over RRP

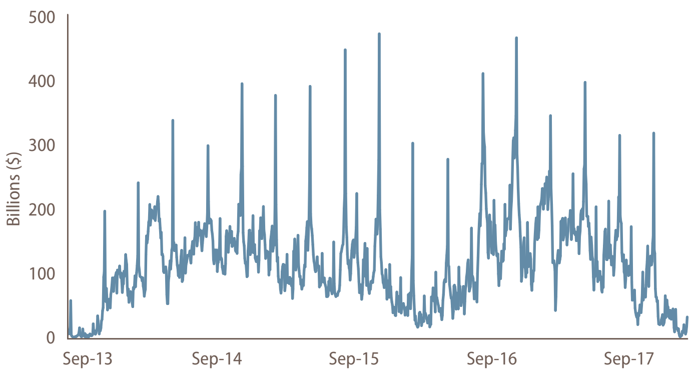


Sources: Federal Reserve Bank, Bloomberg L.P. and the Bank of New York

The change in the government security supply and demand dynamic is most starkly seen in the usage of the Fed's RRP. Since the Fed started the RRP in 2013, it has supported the floor of the Fed's desired overnight interest rate range, and its support has been especially important at quarter-end reporting dates, when regulatory-driven window dressing has led to a contraction in the supply of money market instruments. Every three months, like clockwork, the RRP has been there, filling the supply void created by global banking regulations. As shown in the chart below, the program took in $198 billion in December 2013, the first quarter-end with a fully functional RRP. From that date through December 2017, the average quarter-end RRP usage was $354 billion, and it was never lower than it was on its maiden voyage in 2013. In a telling statement on the degree to which supply has finally caught up with demand, RRP usage on March 29, 2018, quarter-end, was only $33 billion.

Looking ahead, the Treasury's seasonal cash flows likely will shift in April as it swings from paying tax refunds to receiving tax deposits, and T-bill supply should moderate as a result, likely bringing T-bill and repo yields down. However, while seasonality will temporarily temper the trend, it won't change the three fundamental drivers of the changed supply picture: Tax reform has the government collecting less, the budget has the government spending more, and the Fed's balance sheet normalization has it buying fewer Treasuries. Until those factors change, supply and demand look set to be much better balanced than they had been for most of the postcrisis decade.

Fed RRP volume



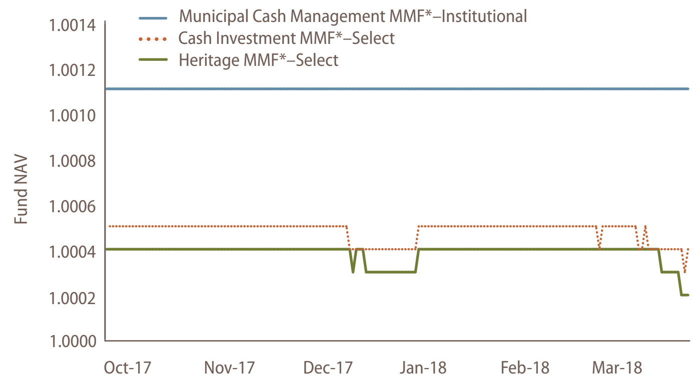
Sources: Federal Reserve Bank and Bloomberg L.P.

Municipal sector

The municipal money market yield curve flattened as rates on the short end rapidly adjusted higher in response to the FOMC's latest tightening. Yields on overnight and weekly variable-rate demand notes (VRDNs) and tender option bonds (TOBs) began to rise fairly early in the month due to a combination of lackluster reinvestment demand and rapidly escalating rates in the taxable sector. The Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index[1] ultimately finished the month at 1.58%, up from 1.09% at the end of February. Quarter-end and tax-time pressures helped push the SIFMA/LIBOR ratio from 0.74% in February to 0.91% at the end of March, attracting some attention from crossover buyers. Further out on the curve, levels on high-grade fixed-rate paper adjusted higher as well, with yields in the one-month to six-month space increasing approximately 35 bps to the 1.50%–1.55% range. However, yields on benchmark one-year paper backed up a relatively modest 23 bps, closing out the month at 1.63%.

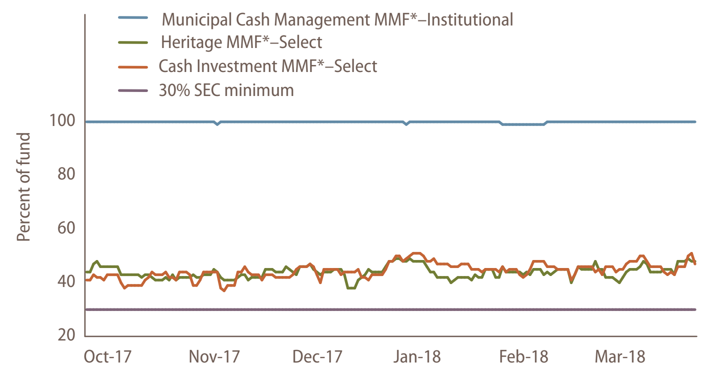
During the month, we continued to maximize our exposures to the short end of the curve by focusing our purchases on daily and weekly VRDNs and TOBs. This strategy allowed us to quickly capture higher market-level yields on floating-rate securities while maintaining an emphasis on liquidity and principal preservation. And while supply and demand dynamics may continue to result in relatively attractive tax-exempt to taxable ratios in the overnight and weekly sectors, upcoming seasonal tax-payment weakness could put additional upward pressure on those levels and ratios in the near term.

Wells Fargo FNAV money market fund NAVs



Source: Wells Fargo Funds

Wells Fargo FNAV money market fund weekly liquid assets



Source: Wells Fargo Funds

On the horizon

President Trump's imposition of tariffs on a number of imports into the U.S. amplified the increasing amount of trading volatility in risk assets during the month. While speculation about tariffs at the beginning of the month was enough to spark stock market intraday trading swings of hundreds of points, by the end of the month the identity and amounts of tariffs that were imposed caused markets to virtually match lows achieved in February and erase all gains—and indeed turn negative—for the year. Fears of sparking a global trade war, as well as effects on the economy and the implications for GDP, seem to be driving investor sentiment and have even brought into the debate the possibility of the U.S. spiraling into its first recession since 2008's Great Recession.

If past performance is any indication of future results, at least as far as the Fed is concerned, this may temper any acceleration or even slow future rate increases. While the Fed has faced periods of volatility in the past and has taken steps to reassure and calm markets, this will be the first test with a new chair, and so it remains to be seen how this Fed will react—or even if it will. Policy-induced market jitters have seemed to characterize markets during this administration, with the vast majority seeming to resolve themselves—either by participants coming to terms with their fears or by the prospect of the next big thing on the horizon. So maybe this latest round of volatility will resolve itself as well. The good news for participants in the money markets is that this sector remains relatively calm and unaffected by those types of events.

Rates for sample investment instruments — current month-end % (March 2018)

Sector	1 day	1 week	1 month	2 month	3 month	6 month	12 month
U.S. Treasury repos	1.79	1.80	–	–	–	–	–
Fed reverse repo rate	1.50	–	–	–	–	–	–
U.S. Treasury bills	–	–	1.61	1.64	1.70	1.88	2.04
Agency discount notes	1.57	1.52	1.62	1.66	1.71	1.81	1.91
LIBOR	1.70	1.75	1.88	2.00	2.31	2.45	2.66
Asset-backed commercial paper	1.75	1.78	1.93	2.13	2.30	2.52	–
Dealer commercial paper	1.69	1.72	1.84	1.95	2.04	2.27	–
Municipals	1.72	1.58	1.50	1.52	1.54	1.57	1.63

Sources: Bloomberg L.P. and Wells Capital Management

Wells Fargo Fund	7-day current yield
Cash Investment MMF*–Select	1.80
Heritage MMF*–Select	1.79
Municipal Cash Mgmt MMF*–Inst	1.35
Government MMF**–Select	1.52
Treasury Plus MMF**–Inst	1.45
100% Treasury MMF**–Inst	1.39

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, wellsfargofunds.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 1.66%, 1.66%, 1.24%, 1.45%, 1.42%, and 1.19%, 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:

Institutional Sales Desk: **1-888-253-6584**

Website: wellsfargofunds**.com** (*Click "Institutional Cash Management"*)

1. 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.

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