WELLS FARGO | ASSET MANAGEMENT

Portfolio Manager Commentary

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

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Sector views

U.S. government sector

The Federal Reserve (Fed) releases its meeting minutes on the Wednesday three weeks after the meeting's conclusion. It's usually a sleepy affair, with bond market strategists reading tea leaves by weighing the input of a *few* committee members against opinions held by *several*, which are usually eclipsed by those agreed upon by *many*. Observers are left to guess which committee members belong to which group, as not all committee members are created equal, with the chair, vice chair, and New York Fed president the most exalted. Besides serving as the historical record of the meeting, investors perceive an additional feature of the minutes as an opportunity for the Fed to fine-tune the message put forth in the meeting statement, particularly in cases the Fed feels the market may have partially misinterpreted the statement. It's essentially another tool in the Fed's communication toolbox.

Money market investors, while obviously caring deeply about the Fed's potential interest rate path, also have occasionally found gems in the minutes about monetary policy implementation, details that might matter greatly to the money markets but are afterthoughts to longer-term investors. For example, the development and evolution of the Fed's reverse repurchase program (RRP) over the past five years was revealed bit by bit over time in the minutes. The minutes of the May 1–2 meeting, during which the Federal Open Market Committee (FOMC) took no actions on interest rates and just tweaked its statement, were released on May 23. They contained one of those implementation gems—a proposed "small technical realignment of the interest on excess reserves (IOER) rate relative to the top of the target range for the federal funds rate," as the minutes reported.

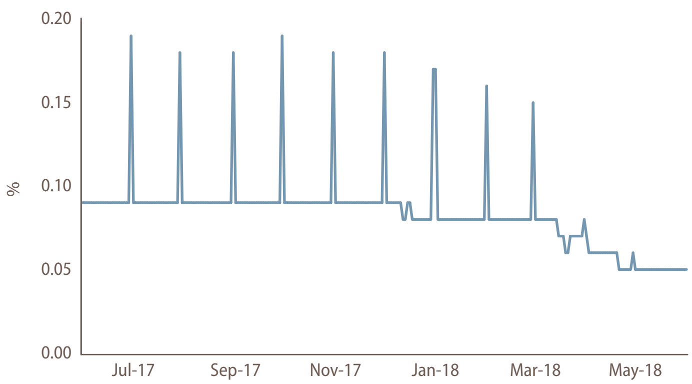
In the end, this adjustment is about keeping the federal funds effective (FFE) rate, lately at 1.70%, comfortably in the Fed's target range, currently set at 1.50% to 1.75%. If the FFE rate were to consistently stray from the target range—which it could, given that the federal funds market is, after all, ultimately governed by the actions of many individual participants—investors could begin to doubt the Fed's ability to credibly implement monetary policy. Essentially, the FFE rate had lately begun trading nearer to the top of the target range than the Fed was comfortable with, and it expects to take a modest step to move the FFE rate back down in the range.

As with so many things, the Fed's current approach to monetary policy implementation bears the marks of the financial crisis. When money market investors were lost in the zero-interest-rate woods for years, with the Fed's balance sheet growing as a result of quantitative easing, the

Fed was more concerned about the FFE rate falling through the floor of its target range, set for years at 0.00% to 0.25%. To provide a solid foundation under the lower bound of the target range, the Fed created the aforementioned RRP in 2013, providing an effectively limitless supply of Treasury collateral to the market at a rate of 0.05%. At the time, the Fed paid banks IOER of 0.25%. With its liftoff rate hike in 2015 to a target range of 0.25% to 0.50%, the Fed set the RRP at 0.25% and the IOER at 0.50%. Thus began a period where two Fed-administered rates marked the lower and upper bounds of its FFE target range. Immediately before and after that initial hike, the FFE rate typically traded right around the middle of the Fed's range, or about 0.12% to 0.13% below the top of its range and the IOER.

As noted earlier, with the FFE rate currently at 1.70%, the spread between it and the IOER has shrunk to 5 basis points (bps; 100 bps equal 1.00%), down from 9 bps just in the past six months. The change in the IOER/FFE spread over the past year is shown in the chart below.

Excess of IOER over FFE



Source: Bloomberg L.P.

The Fed put forth its understanding of the cause of the narrowing spread as follows:

"In large part, this development seemed to reflect a firming in rates on repurchase agreements (repos) that, in turn, had resulted from an increase in Treasury bill issuance and the associated higher demands for repo financing by dealers and others. Higher rates had reportedly made repos a more attractive alternative investment for major lenders in the federal funds market, thus reducing the availability of funding in that market and putting some upward pressure on the federal funds rate."

As the FFE rate rose in the range and that spread narrowed, the Fed apparently felt the heat, and its technical adjustment is the result. Specifically, the proposed technical realignment would keep the RRP rate at the bottom of the FFE range but move the IOER rate down 5 bps, setting it 5 bps below the top of the FFE range. In terms of timing:

"[M]any participants judged that it would be useful to make such a technical adjustment sooner rather than later. Participants generally agreed that it would be desirable to make that adjustment at a time when the FOMC decided to increase the target range for the federal funds rate …"

If the realignment happens concurrently with an expected June rate hike, and it should, as the minutes note that the many have blessed such a move, then the new FFE target range in mid-June will be 1.75% to 2.00%, with the RRP set at 1.75% and the IOER set at 1.95%. The Fed apparently feels that the relative lowering of IOER will help keep the FFE well within the target range by bringing the rates on all short-term instruments down.

As for its market impact, this was a perfect example of a tweak to the Fed's plumbing that will have no real impact on either the Fed's interest rate path or its impact on the economy. However, it did have a material impact on the money markets, as the yields on Treasury bills and other instruments were marked lower by around 5 bps within a day of the publication of the minutes. Time will tell how the FFE and repo rates are affected by the Fed's change, but we won't likely have to wait long to find out, as it's expected to take place at the conclusion of the Fed's next meeting on June 13.

Prime sector

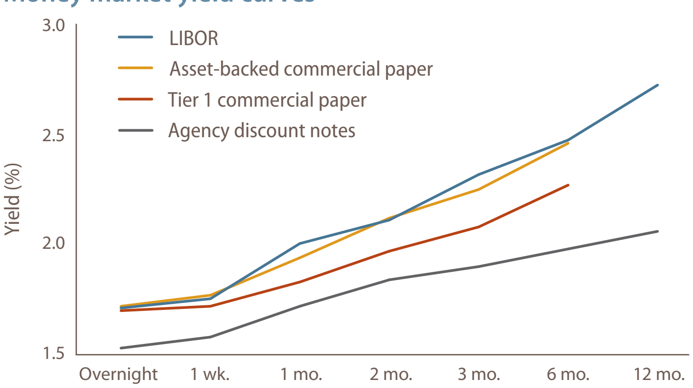
As expected, the FOMC left its target rate unchanged at a range of 1.50% to 1.75% after its May 2, 2018, meeting. Similarly, the corresponding statement made very few changes to the March statement but did acknowledge that inflation is now expected to run near its 2% objective over the medium term, as both overall inflation and inflation excluding food and energy have edged closer to 2% on a 12-month basis. On the economic front, non-farm payrolls added 223,000 new jobs in May, pushing the unemployment rate down to 3.8% and matching the 1960–1969 and 1991–2000 cycle lows. In addition, monthly average hourly earnings rose 0.3%, bringing year-over-year growth up to 2.7%. Overall, it appears the FOMC is comfortable with the current above-trend growth, low unemployment, and moderate inflation, and inflation expectations continue to support additional rate hikes.

As is typical following a policy meeting, the Fed rolled out a slate of speakers to clarify any potential questions after its meeting. In what appears to be a far more careful approach to communicating monetary views, practically every speaker toed the party line in some way, shape, or form. Specifically, that the economy was progressing as expected and that while inflation was expected to continue to firm, it was not expected to accelerate rapidly. The symmetric approach to inflation targeting mentioned in the policy statement was also confirmed by several speakers. For example, in her speech to the Forecasters Club of New York, Federal Reserve Governor Lael Brainard shared her view:

"Continued gradual increases in the federal funds rate are likely to be consistent with sustaining strong labor market conditions and inflation around target … this outlook suggests a policy path that moves gradually from modestly accommodative today to neutral—and, after some time, modestly beyond neutral."

As you may recall, the FOMC's Summary of Economic Projections at its March meeting suggested that it was a close call if its target rate would be raised three or four times this year; the current data set, combined with the careful approach to communicating monetary views, shouldn't change that projection. Although the Summary of Economic Projections after the Fed's June meeting will offer further guidance on the path of its target rate, current federal funds futures implied probabilities confirm the market is in agreement with the FOMC assessment that rate hikes are mostly priced in for June and September meetings, with roughly a 50% chance at its December meeting.

Money market yield curves

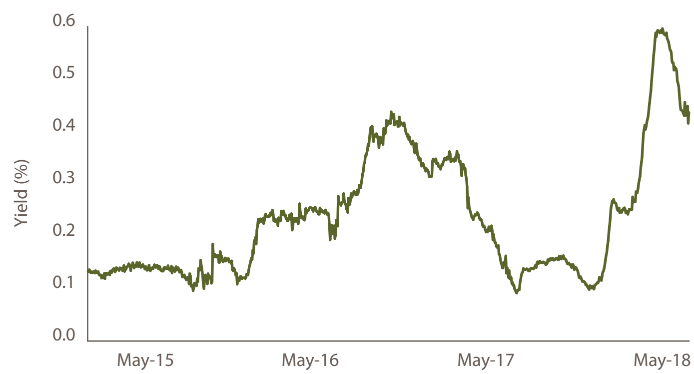


Sources: Bloomberg L.P. and Wells Capital Management Inc.

As the FOMC remains on its path to remove accommodation and markets continue to price in future rate hikes, cash is becoming a more attractive asset class as investors become more able to pick up incremental yield while taking on minimal duration risk. Both commercial paper outstandings and assets in the institutional prime sector increased in May. Commercial paper was up across all segments—financials, nonfinancials, and asset-backed commercial paper—by a total of $18 billion on a non-seasonally-adjusted basis. Prime institutional sector assets were up $2.9 billion during the month of May and year-to-date prime institutional assets are up roughly $10 billion (according to Crane Data). The amount of paper being invested 41 days and out dropped from 15.2% of commercial paper written in April to 12.6% in May as investors shortened up to take advantage of the expected June rate hike; the added demand for short-dated maturities, in turn, kept a lid on prime asset yields.

The London Interbank Offered Rate-Overnight Investment Swap (LIBOR-OIS) spread continued to narrow off its dramatic March widening. We saw the spread decrease 6 bps in the second half of April and another 9 bps in May as the supply/demand imbalances continue to work out of the system. Some of the factors that caused the dramatic widening have played themselves out or the actual news wasn't as impactful as expected. For example, the ramp up in T-bill issuance in March ($332 billion) after the resolution of the debt ceiling was followed by a $120 billion reduction of issuance in April as tax receipts reduced the need to issue bills, allowing demand to catch up with supply. And May was a fairly ordinary T-bill issuance month with roughly $17 billion of net new supply meeting sufficient demand to keep yields in check.

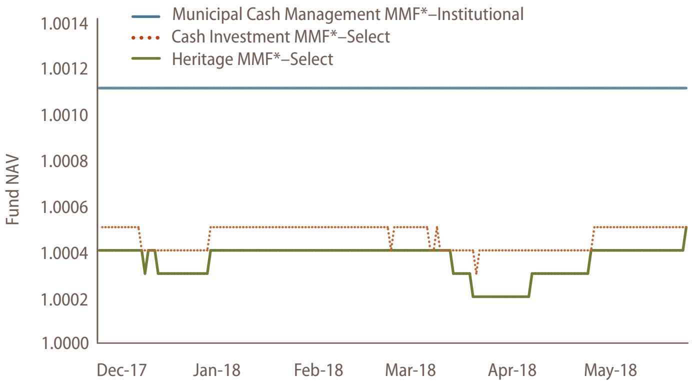
LIBOR-OIS spread



Sources: Bloomberg L.P. and Wells Capital Management

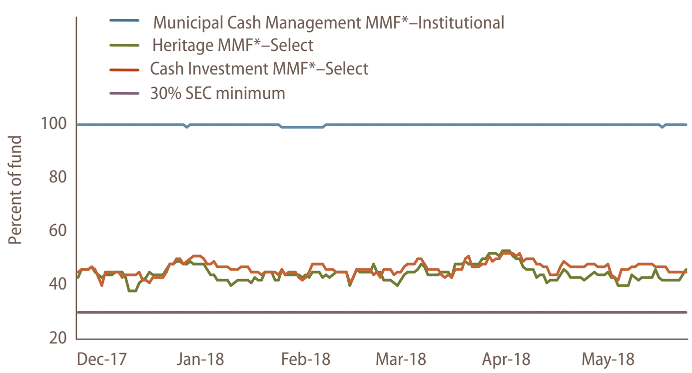
Against a backdrop of favorable economic conditions and an FOMC that is anticipating removing accommodation for the foreseeable future, we continue to favor maintaining our funds' weighted average maturities shorter than the industry average and maintaining a high degree of interest rate sensitivity. These shorter profiles also afford us the flexibility to add longer-dated products as opportunities arise. While rates in general continue to drift higher, we believe our investment strategy of emphasizing highly liquid portfolios, relatively short weighted average maturities, and a position in securities that reset frequently will allow us to capture future FOMC rate moves with minimal net asset value (NAV) pricing pressures.

Wells Fargo FNAV money market fund NAVs



Source: Wells Fargo Funds

Wells Fargo FNAV money market fund weekly liquid assets



Source: Wells Fargo Funds

Municipal sector

After experiencing outflows of roughly $4 billion during March and April due to seasonal tax payments, municipal money market fund assets staged a remarkable turnaround during the month of May, increasing an astounding $6.2 billion, according to Crane Data. Investors looked to take advantage of the sudden increase in attractiveness of municipals as the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index[1] spiked to a multiyear high of 1.81% on April 18, up from 1.58% at the end of March. Crossover and traditional investors alike were quickly attracted to the municipal sector following the meteoric rise in rates that resulted in the SIFMA/1-week LIBOR breaking the 100% barrier during the month of April.

But, as they say, all good things must come to an end. Reinvigorated demand rapidly began to push yields on overnight and weekly variable-rate demand notes (VRDNs) and tender option bonds (TOBs) back down to more modest levels throughout the month of May. The SIFMA Municipal Swap Index reset lower for six straight weeks before closing out the month at 1.06%, or 61% of 1-week LIBOR. Further out on the curve, yields on tax-exempt high-grade paper fell in sympathy with floating-rate securities, with yields on high-grade commercial paper falling approximately 35–45 bps in the one-month to three-month space. However, yields on top-notch one-year paper were relatively immune to the volatility experienced in the short end, falling roughly 8 bps to 1.70% during the course of the month.

Despite the rapid but somewhat expected drop in rates in the short end during the month, we continued to emphasize principal preservation and liquidity by targeting our purchases in VRDNs and TOBs with daily and weekly puts. We feel that this sector of the curve allows us to maximize liquidity and stability of principal, and minimize the risk of implementing fees and gates. Additionally, it may offer attractive nominal and after-tax returns for tax-sensitive investors and a high degree of interest rate sensitivity, given the expectations of a hike in rates by the FOMC in June, with subsequent moves priced into the market during the second half of the year.

On the horizon

If it is not yet apparent at this point in the commentary, June 13 is a date upon which all sectors of the money markets will be focused like kids at Christmas. About the only time there was a smidgen of doubt this month that we may not get a gift from the Fed in the form of higher interest rates was during the very short-lived Italian political crisis—about 48 hours or so—in which the possibility of contagion made the rounds and risk assets sold off. During that time, calculated probabilities for a tightening shrank a bit, but the money markets themselves proved relatively stable and immune to contagion; indeed, following news of the formation of a new government, the odds of the Fed tightening at the June meeting rebounded to precrisis levels in the general vicinity of near certainty. Once that passes, we can transfer our prognostications to the next meeting in September. These two meetings will likely bookend what is traditionally one of the more quiet times in the money markets—summer. A scan of the horizon reveals little evidence of impending disturbances to that tranquility.

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

Sector	1 day	1 week	1 month	2 month	3 month	6 month	12 month
U.S. Treasury repos	1.78	1.77	–	–	–	–	–
Fed reverse repo rate	1.50	–	–	–	–	–	–
U.S. Treasury bills	–	–	1.71	1.78	1.86	2.03	2.16
Agency discount notes	1.53	1.58	1.72	1.84	1.90	1.98	2.06
LIBOR	1.71	1.75	2.00	2.11	2.32	2.47	2.72
Asset-backed commercial paper	1.72	1.77	1.94	2.12	2.25	2.46	–
Dealer commercial paper	1.70	1.72	1.83	1.97	2.08	2.27	–
Municipals	0.93	1.06	1.30	1.35	1.40	1.52	1.70

Sources: Bloomberg L.P. and Wells Capital Management

Wells Fargo Fund	7-day current yield
Cash Investment MMF*–Select	1.95
Heritage MMF*–Select	1.96
Municipal Cash Management MMF*–Inst	1.08
Government MMF**–Select	1.67
Treasury Plus MMF**–Inst	1.56
100% Treasury MMF**–Inst	1.58

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.*

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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 1.84%, 1.86%, 0.98%, 1.59%, 1.54%, and 1.38%, 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.

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