Morgan Stanley

INVESTMENT MANAGEMENT

Market Insights

Fed Maintains Positive Outlook Despite Economic Slowdown

LIQUIDITY | GLOBAL LIQUIDITY TEAM | MAY 2017

Overview[1]

In its May meeting, the Federal Open Market Committee (FOMC) voted to keep interest rates unchanged, which was largely expected by the markets. The FOMC noted that economic activity has "slowed" and that household spending increased "modestly." Despite acknowledging that there has been some slowdown, the FOMC still maintains a positive long-term outlook for the markets and economy. Additionally, the FOMC believes the weaker economic readings are temporary.

First-quarter gross domestic product (GDP) was revised upward to an annualized rate of 1.2% from the previously reported 0.7%. The initial GDP reading surprised investors as the FOMC had communicated that the economy was approaching full employment. Inflation also was a bright spot of the meeting, as it is approaching the FOMC's 2% target. Going forward, the meeting laid the groundwork for a potential interest rate hike pending upcoming economic data.

The markets are pricing in an interest rate hike at the June FOMC meeting, provided that markets and economic data remain stable. This is consistent with the March Summary of Economic Projections, which called for two more rate hikes in 2017.

In the eurozone, politics continued to be a focal point for investors. This was the case especially in France, where Emmanuel Macron won the second round of the French election by a wide margin. Macron's victory was widely expected. First-quarter GDP in the eurozone increased by 0.5% quarter-over-quarter, which was consistent with market forecasts. Inflation decreased to 1.4% in May, which was disappointing as some European policymakers have expressed interest in scaling back its quantitative easing program.

Similar to the eurozone, political uncertainty in the United Kingdom was evident during May, as the general election will take place during the first week of June. The outcome of the election will dictate how the Brexit negotiations will play out.

[1] Source: Bloomberg.

DISPLAY 1

Monthly Interest Rate Summary

As of 5/31/2017

US TREASURY RATES	YIELD (%)	MOM CHANGE (%)
1M UST	0.86	0.20
3M UST	0.97	0.18
6M UST	1.07	0.10
12M UST	1.15	0.09
2Y UST	1.28	0.02
5Y UST	1.75	(0.06)
10Y UST	2.20	(0.08)
30Y UST	2.86	(0.09)
USD LIBOR CURVE		
O/N LIBOR	0.93	(0.00)
1M LIBOR	1.06	0.07
3M LIBOR	1.21	0.04

Source: Bloomberg

Strategy

PRIME STRATEGY[2]

As widely expected, the Federal Reserve (Fed) voted unanimously to keep interest rates unchanged at its May meeting. Markets remained focused on domestic economic data releases and geopolitical headlines from around the world. As Fed officials project a gradual approach to tightening monetary policy for the remainder of 2017, we continued to manage our Portfolios from a conservative positioning standpoint, focusing on high levels of weekly liquidity and structuring our Portfolios to help minimize interest rate risk that could arise from future interest rate hikes. We continued to invest in both fixed- and floating-rate securities, focusing on final maturity date for fixed rate and reset dates for floating rate, as we position the Portfolios for a rising rate environment.

GOVERNMENT/TREASURY STRATEGY[3]

Yields on Treasury and agency securities moved higher as the month progressed, reflecting growing market sentiment that the FOMC will increase interest rates at its June meeting. Demand for short Treasury bills maturing near the next FOMC meeting were strong, with 1-month bills trading through the Federal Reserve's Reverse Repurchase Facility rate of 0.75% for most of the month. The U.S. Treasury kept supply unchanged for most of May. Near month-end, it reduced the 1-month bill supply by $10 billion and issued a $25 billion cash management bill to June 15. We expect a June rate hike, and this short maturity helped investors with that same view maintain maturing cash near the next FOMC meeting date. We continued to selectively invest in agency and Treasury floating-rate notes and bought fixed-rate debt within 3-month tenors. We continued to maintain a significant portion of certain Portfolios in short-term repurchase agreements.

TAX-EXEMPT STRATEGY[2]

At the short end of the curve, yields for variable rate demand obligations (VRDOs) dropped throughout the month of May. The SIFMA Index,[4] which measures yields for weekly VRDOs, fell 0.14% over the course of the month. At the long end of the money market range, there was very little new financing and the Municipal Market Data (MMD) One-Year Note Index closed the month unchanged. June typically has some of the largest coupon inflows of the year, which may place additional downward pressure on variable rate yields. We maintained our emphasis on high levels of liquidity and very short duration. We will continue to watch and see how monetary policy unfolds and to see what tax reform proposals will be put forth by Congress, and determine what impact–if any–such reforms may have on municipal yields.

[2] The Portfolio will be required to price and transact in their shares at a floating net asset value ("NAV") and will be permitted to impose a liquidity fee on redemptions or temporarily restrict redemptions in the event that the Portfolio's weekly liquid assets fall below certain thresholds.

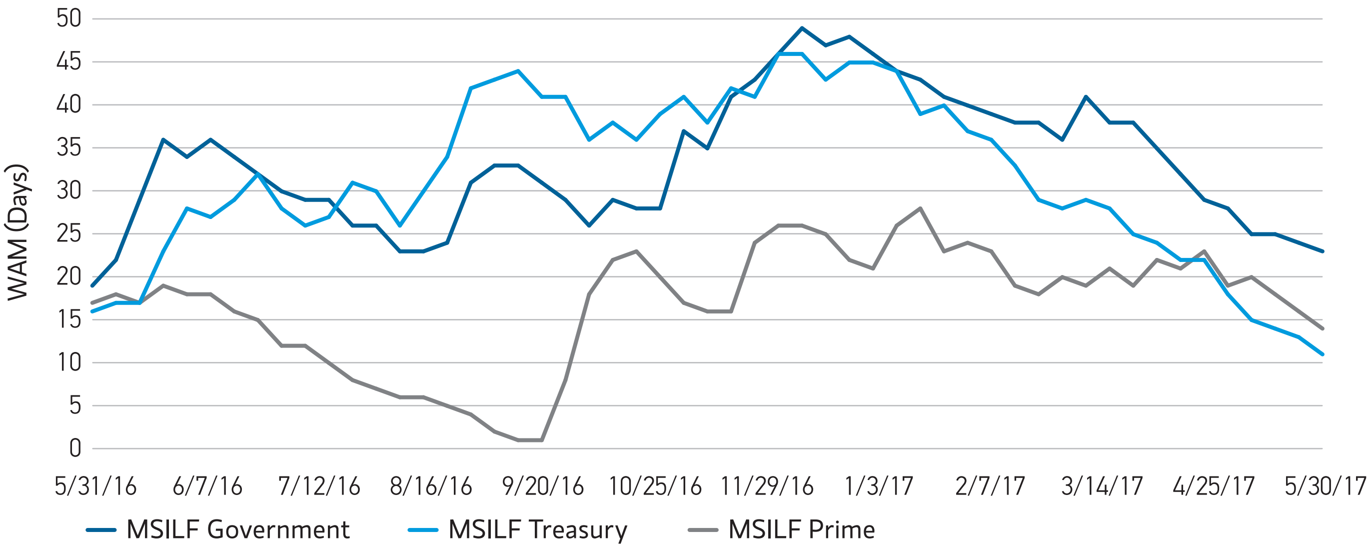
[3] Government and Treasury Funds are Stable NAV funds.

[4] The **SIFMA Index** is issued weekly and is compiled from the weekly interest rate resets of tax-exempt variable r ate issues included in a database maintained by Municipal Market Data which meet specific criteria established from time to time by The Bond Market Association. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

DISPLAY 2

Morgan Stanley Institutional Liquidity Funds (MSILF) Weighted Average Maturities (WAM)

5/31/2016 – 5/30/2017



Source: Bloomberg

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Please consider the investment objectives, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund and can be obtained by contacting your financial professional, or by downloading a copy at www.morganstanley.com/liquidity. Please read the prospectus carefully before investing.

STABLE NAV 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 Funds' 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.

FLOATING NAV 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 the 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 Funds' 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.

The Tax-Exempt Portfolio may invest a portion of its total assets in bonds that may subject certain investors to the federal Alternative Minimum Tax (AMT). Investors should consult their tax adviser for further information on tax implications.

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