

Euro Liquidity Fund

Morgan Stanley Funds p.l.c.

Launch date:

June 2003

Portfolio manager:

Corinne Lewis-Reynier

Location:

London

Base currency:

Euro

Benchmark:

1 Week Euro LIBID

MARKET REVIEW

Crisis conditions continued in October. Equity prices plunged as investors began to recognise the magnitude of the recession touched off by the dysfunction in credit markets. Credit markets remained under severe pressure and yield spreads widened massively. Government bond yields plunged, especially at shorter maturities. The Bank of England joined a coordinated global policy easing early in October and reduced rates further, to 3% in early November.

While markets remain turbulent, there was evidence last month that EU economic policies were beginning to get a grip on problems in the financial system. While each country's approach has differed, the general strategy has featured a massive provision of liquidity through central banks and powerful support to commercial banks through capital injections and asset purchases. The total amount of public resources deployed in these operations – estimated at more than \$4 trillion by the Bank of England – became comparable to the scale of the problem, as shown by declines in money market rates and credit spreads on the debt of large financial institutions.

The good news in money markets was not enough to spare credit markets a second straight month of historic underperformance. Despite credit spreads already being near the highest levels of the past 50 years, the collapse in equity prices and recognition that deep recession may lie ahead forced them wider still. The spread move was proportionately more severe for non-financial issuers, as government injections of capital and guarantees of at least some liabilities provided support for bank debt. Despite lower yields on government debt, the magnitude of the spread widening has forced corporate borrowing costs sharply higher, posing yet another risk to economic activity.

Markets priced in a sharply lower path of monetary policy rates through next year following poor economic reports. The Bank of England participated in a coordinated rate cut of 50 basis points on 8 October and cut again by an unprecedented 150 basis points, to a 3% base rate, early in November.

October was the first full month following the September freeze in money and credit markets and data began to reveal the extent of the damage to economies. Survey data plunged to recession-like levels in Japan, Europe and North America. In Europe, confidence is still around the levels of a moderate recession, but in the US and Japan the readings are more consistent with the deeper downturns of the 1970s and 1980s – the deepest recessions in more than 50 years. Most hard economic data still cover the pre-credit crunch period and so do not help reveal the shape of the downturn. The unemployment rate in the euro area was steady in September at 7.5%. This rate will rise in the months ahead if activity is as soft as surveys indicate.

Inflation data continued to be a bright spot, at least, as they indicate an unwinding of the inflation scare of the past summer. The annual rate of inflation in the euro area fell to 3.2% in October, according to the flash estimate and it is expected to fall below 3% in November. ECB President Trichet indicated he expected further declines next year and that inflation was no longer an obstacle to setting monetary policy to support economic expansion.

STRATEGY AND OUTLOOK

Given the uncertain outlook and market volatility, the investment strategy in the fund continued to be prudent and defensive in nature. We remain conservative in our approach to both credit, duration and liquidity management.

During the month, the euro Libor money market yields declined sharply on the back of Central Bank liquidity injection and interest rates easing. The one-month Libor rate was 65 bps lower to 4.42%; the three-month rate was down 51 bps at 4.77%, while the 12-month rate decreased by 62 bps to 4.87%.

At the end of the month, the 30-day gross yield to maturity on the fund was 4.53% with a weighted average maturity (WAM) of 34 days. Asset allocation at the end of the period was as follows: Commercial Paper 41%, Floating Rate Notes 19%, Certificates of Deposit 9%, Short dated Government Bills 11% and Time Deposits 20%.

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