Morgan Stanley

INVESTMENT MANAGEMENT

Market Insights

Central Banks Close the Year on a Quieter Note

LIQUIDITY | GLOBAL LIQUIDITY TEAM | INVESTMENT INSIGHT | DECEMBER 2019

Federal Reserve Board[1]

The Federal Reserve (Fed) convened on December 10, 2019 for its last meeting of the year. Chairman Jerome Powell and the Federal Open Market Committee (FOMC) voted to keep the federal funds rate unchanged at 1.50%-1.75%. Chairman Powell signaled to the market that the Fed is comfortable with current policy and will take a "wait and see" approach going forward. The Federal Reserve press release stated,

> The Committee judges that the current stance of monetary policy is appropriate to support sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective. The Committee will continue to monitor the implications of incoming information for the economic outlook, including global developments and muted inflation pressures, as it assesses the appropriate path of the target range for the federal funds rate.

The past year was eventful for the Fed and Chairman Powell. Entering 2019, investors expected rates to rise systematically during the year, but received quite the opposite policy action.

DISPLAY 1

Monthly Interest Rate Summary

As of 12/31/19

US TREASURY RATES	YIELD (%)	MOM CHANGE (%)
1M UST	1.43	(0.16)
3M UST	1.54	(0.02)
6M UST	1.58	(0.02)
12M UST	1.57	(0.02)
2Y UST	1.57	(0.04)
5Y UST	1.69	0.07
10Y UST	1.92	0.14
30Y UST	2.39	0.18
USD LIBOR CURVE		
O/N LIBOR	1.54	0.00
1M LIBOR	1.76	0.07
3M LIBOR	1.91	0.00

Source: Bloomberg

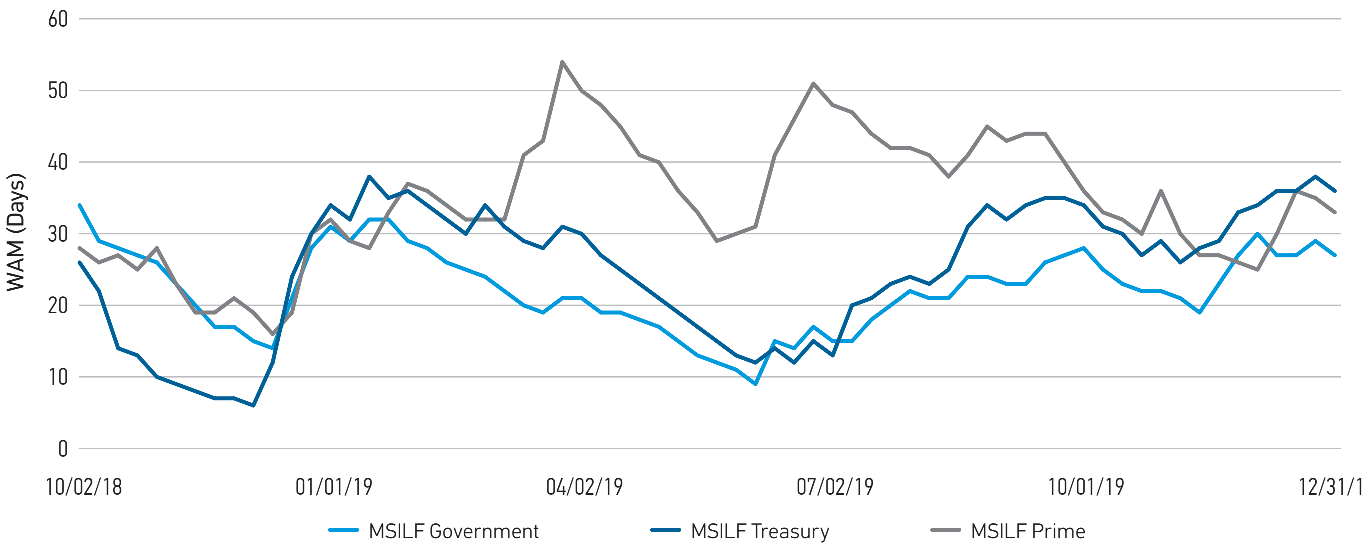
[1] Source: Bloomberg.

The views and opinions expressed are those of the Portfolio Management team as of December 2019 and are subject to change based on market, economic and other conditions. **Past performance is not indicative of future results.**

DISPLAY 2

Morgan Stanley Institutional Liquidity Funds (MSILF) Weighted Average Maturities (WAM)[2]

As of 12/31/19



Source: iMoneyNet

Chairman Powell and his committee had to navigate the murky waters of global trade tension, economic uncertainty, lower than expected inflation and global economic growth deceleration. In response, the Fed cut rates three times to help bolster the economy. Going into the new decade, market consensus expects the Fed to keep rates unchanged throughout 2020. That being said, Chairman Powell has suggested if data (i.e., inflation, employment) changes materially, the committee stands ready to act in any way necessary. In 2020, data must be monitored closely, as policy could pivot at any moment's notice, something investors learned in 2019.

European Central Bank[1]

The European Central Bank (ECB) met on December 12, 2019, marking Christine Lagarde's first meeting as ECB president. President Lagarde and the policy committee kept ECB interest rates unchanged at -0.50%. The committee noted it expects this rate to remain at or below its current level for the foreseeable future. The committee is looking for inflation to robustly increase towards 2% before considering tightening policy. President Lagarde also mentioned that the ECB's asset purchase program will remain in effect until it is no longer needed to support the economy.

Data that the ECB considers when making policy decisions continue to show muted inflation and weak economic growth in the region. It remains to be seen when such data will stabilize, but until then Christine Lagarde and the ECB look likely to continue accommodating all sectors of the economy.

Bank of England[1]

The Bank of England (BOE) Monetary Policy Committee (MPC) met on December 19, 2019 and voted 7-2 to maintain the Bank Rate at 0.75%.

Since the MPC last gathered, economic data has been relatively in line with projections. The ratcheting down of global trade tensions, some Brexit clarity and potentially stabilizing global financial conditions have given the MPC reason to be a bit more optimistic looking forward. However, growth in job vacancies and the potential of a loosening labor market have the MPC eyeing the data carefully.

Brexit uncertainty remains elevated. The potential for a smoother Brexit outcome would allow the MPC to chart a clearer course and could potentially lead to policy actions to stave off inflation. However, that is not the base case scenario and certainly not what policy makers expect. Markets will also be watching the BOE governorship transitioning to Andrew Bailey from Mark Carney in late January. The decision was long overdue, with Brexit and other situations further delaying the announcement. The new governor steps

[2] **Weighted Average Maturity (WAM):** Measures the weighted average of the maturities of the portfolio's individual holdings, taking into account reset dates for floating rate securities.

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into his role as the U.K. enters the next phase of Brexit negotiations. Investors must carefully monitor the new governor as he leads the central bank through an uncertain time. 2020 is shaping up to be a very eventful year for the MPC.

Portfolio Strategy

PRIME STRATEGY[3]

As widely expected, the Fed left interest rates unchanged at its December meeting, while signaling it would keep them on hold through 2020. The Fed indicated that "the current stance of monetary policy is appropriate to support sustained expansion of economic activity, strong labor market conditions and inflation near the committee's symmetric 2% objective." With elevated year-end stress in the wholesale funding market, 3-month LIBOR touched recent highs, peaking on December 24 at 1.96%, a 6 basis point increase compared to November 29. On the month, we opportunistically added both fixed and floating rate securities to the portfolios, predominantly in the 6- to 9-month tenors. Floating rate securities were weighted towards quarterly resets, enabling the portfolios to lock in an elevated coupon setting for the first three months of the trade. As we look ahead to 2020, we continue to manage our portfolios from a conservative positioning standpoint, maintaining our emphasis on high levels of weekly liquidity and structuring our portfolios to respond to changes in monetary policy.

GOVERNMENT/TREASURY STRATEGY[4]

The repo markets were well behaved in December, with overnight repo rates only moving a touch higher on year-end, due the vast amount of liquidity provided by the Fed to primary dealers with the combination of overnight and term repos. Overnight repo rates averaged 1.55% on year-end, slightly higher than what we saw most of the month. During the month, we invested in fixed-rate Treasuries and agencies in predominately 3- to 6-month maturity tenors and favored longer-term floating rate notes. At the December meeting, the FOMC remained on hold with its rate policy, as the environment remained supportive for economic expansion. We continued to maintain a large portion of the portfolio in repurchase agreements and manage the portfolio to be responsive to changes in market and rate conditions.

TAX-EXEMPT STRATEGY[3]

At the short end of the curve, yields for variable rate demand obligations (VRDOs) rose significantly during the month of December. The SIFMA Index,[5] which measures yields for weekly VRDOs, rose from 1.06% at the beginning of the month to finish the month at 1.61%. Yields at the longer end of the municipal money market maturity range, on the other hand, trended lower during the month. The Municipal Market Data One-Year Note Index[6] finished the month at 1.14%, down 0.04% from the prior month. We continue to watch how monetary policy unfolds and determine what impact it may have on municipal yields.

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[3] 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.

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

[5] The **SIFMA Municipal Swap** index is a 7-day high-grade market index comprised of tax-exempt VRDOs reset rates that are reported to the Municipal Securities Rule Making Board's (MSRB's) SHORT reporting system.

[6] **Thomson Reuters Municipal Market Data (MMD) AAA Curve** is a proprietary yield curve that provides the offer-side of "AAA" rated state general obligation bonds, as determined by the MMD analyst team. The "AAA" scale (MMD Scale), is published by Municipal Market Data every day at 3:00 p.m. eastern standard time with earlier indications of market movement provided throughout the trading day. The MMD AAA curve represents the MMD analyst team's opinion of AAA valuation, based on institutional block size ($2 million+) market activity in both the primary and secondary municipal bond market. In the interest of transparency, MMD publishes extensive yield curve assumptions relating to various structural criteria which are used in filtering market information for the purpose of benchmark yield curve creation. MMD yield curves are available on a subscription basis from Thomson Reuters TM3.

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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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