Morgan Stanley

INVESTMENT MANAGEMENT

Federal Reserve Cuts Again While the ECB Restarts QE

LIQUIDITY | GLOBAL LIQUIDITY TEAM | INVESTMENT INSIGHT | SEPTEMBER 2019

Federal Reserve Board[1]

The Federal Open Market Committee (FOMC) decided to lower the range for the federal funds rate for the second time this year by 0.25% to 1.75%-2.00% on September 18. Chairman Powell and other policymakers justified the rate cut due to slowing global growth and heightening trade tensions between the U.S. and China. Powell remained consistent with his past FOMC meeting committing future Federal Reserve (Fed) policy to "sustain the economic expansion." Inflation remains under the Federal Reserve's target, and economic growth for the second quarter came in at 2.0%.

Overnight repo markets saw a temporary spike in rates which was triggered by corporate taxes and settlement of Treasury coupons. Powell suggested this event was expected, although such occurrence "had a bigger effect than most folks anticipated." Powell suggested the liquidity shortage in the overnight market would not impact the economy as the Fed is actively monitoring the situation and adding liquidity as needed.

Over the course of September, the U.S. and China continued their trade spat. However, China is planning to send a delegation to Washington in early October, which will be closely monitored. There had been much speculation about reaching a smaller, less extensive deal, but this development must be closely watched as dynamics seem to change rapidly with the two counterparties.

DISPLAY 1

Monthly Interest Rate Summary

As of 9/30/19

US TREASURY RATES	YIELD (%)	MOM CHANGE (%)
1M UST	1.86	(0.23)
3M UST	1.81	(0.17)
6M UST	1.81	(0.05)
12M UST	1.74	(0.02)
2Y UST	1.62	0.12
5Y UST	1.54	0.16
10Y UST	1.66	0.17
30Y UST	2.11	0.15
USD LIBOR CURVE		
O/N LIBOR	1.82	(0.27)
1M LIBOR	2.02	(0.07)
3M LIBOR	2.09	(0.05)

Source: Bloomberg

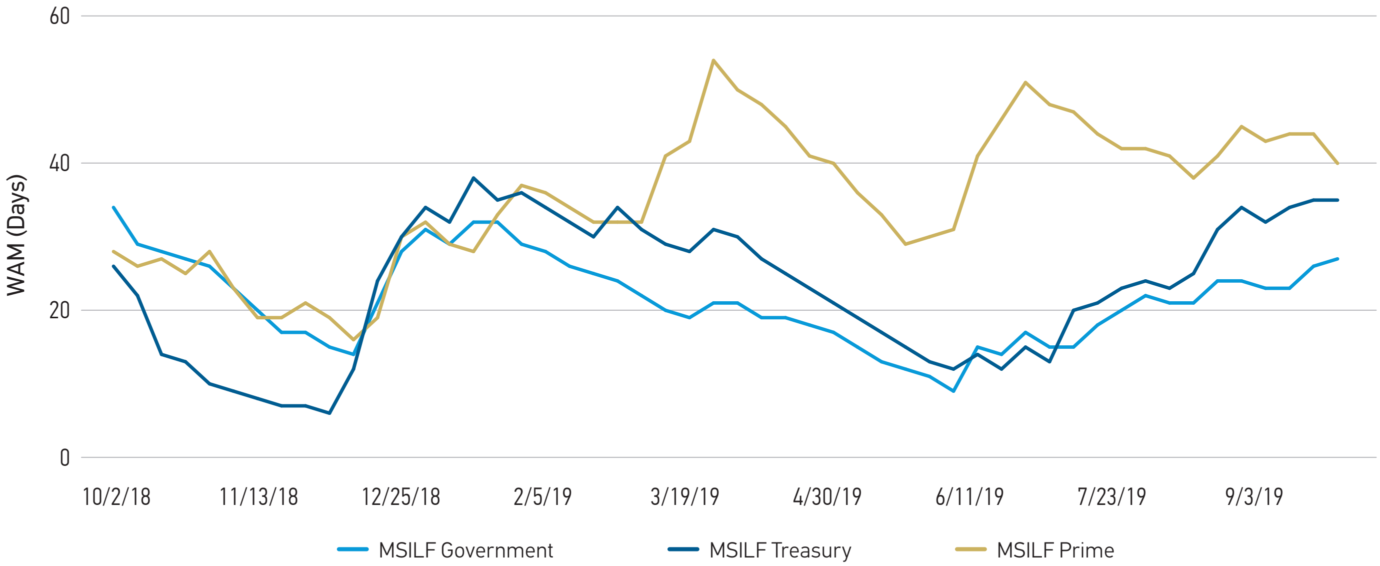
[1] Source: Bloomberg.

The views and opinions expressed are those of the Portfolio Management team as of September 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]

10/02/18-9/24/19



Source: iMoneyNet

Amid accommodative Federal Reserve policy and the potential of a U.S.-China trade deal, investors began paring back U.S. Treasury holdings in September, with the 2-, 5- and 10-year yields rising 12 bps, 16 bps, and 17 bps respectively, throughout the month. As of September 30, the 10-year Treasury bond was yielding 15 bps less than the 3-month Treasury bill. The 5-year Treasury bond was yielding 27 bps less than the 3-month Treasury bill as of the same date.

European Central Bank[1]

In Mario Draghi's penultimate meeting as European Central Bank (ECB) president, the central bank lowered the deposit rate 10 basis points to -0.5% from -0.4%. Draghi cited inflation remaining below the ECB's 2.0% target as reason for the cut. Although Draghi said the chances for a eurozone recession had gone up since their last meeting, that chance remained "small" currently. It is the first time since March 2016 that the ECB has lowered its deposit rate.

Draghi believes risks to the eurozone increased since their last policy meeting due to spillover from global trade tensions and concerns about Brexit fallout. In addition to reducing the deposit rate, the ECB will begin another stimulus package by buying 20 billion euros worth of securities per month starting on November 1, 2019. The previous ECB stimulus package was in place from March 2015 to the end of 2018. With Christine Lagarde stepping into the ECB presidency on November 1, markets will be scrutinizing her policy signals. Typically in the past, she has been well aligned with Draghi, but market participants are awaiting to see how ECB monetary policy develops under her leadership.

Bank of England[1]

The Bank of England (BOE) Monetary Policy Committee (MPC) met on September 19, 2019 and voted unanimously to maintain the bank rate at 0.75%. Additionally, the committee voted unanimously to maintain the stock of sterling non-financial investment grade corporate bond purchases and U.K. government bond purchases. Brexit uncertainties have the MPC ready for action due to the wide range of outcomes.

Portfolio Strategy

PRIME STRATEGY[3]

As widely expected, the Federal Reserve reduced interest rates for the second

[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.

[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.

time this year at the September FOMC meeting, cutting the target for the benchmark policy rate to 1.75% to 2%. While the Fed retained language indicating that it would "act as appropriate to sustain the expansion," the updated dot plot shows a committee divided, with median estimates forecasting no further change to the fed funds rate for the remainder of the year. As spreads widened throughout the month due to quarter-end funding pressures, we opportunistically added floating rate securities to the portfolio, predominantly in the 6- and 9-month tenors. The weighted average maturity (WAM) of the portfolios declined due to floating rate additions throughout the month. As we look ahead towards the fourth quarter of 2019, 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]

At mid-month, overnight rate rates spiked due to the corporate tax day and Treasury coupon settlements, which helped cause a supply/demand imbalance. The following day, the Fed normalized the repo market through its temporary open market operations, injecting needed cash into the system. The Fed continues to conduct these operations daily to limit possible market dislocations while it monitors market developments. Yields on portfolios with larger amounts of overnight repo exposure moved higher on days when overnight repo rates were elevated. At quarter-end, dealer balance sheets became constrained as is typical on month-end. We invested in longer-term agency and Treasury fixed-rate debt, favoring 3-month to 6-month tenors. We also added select Treasury and agency floating-rate notes, the latter indexed off various indices. We continue to manage the portfolios to be responsive to changes in market conditions and interest rate levels.

TAX-EXEMPT STRATEGY[3]

At the short end of the curve, yields for variable rate demand obligations (VRDOs) rose throughout the month of September. The SIFMA Index, which measures yields for weekly VRDOs, increased 0.30% over the course of the month to 1.58%. Yields at the longer end of the municipal money market maturity range also trended higher during the month as investors prepare for a pickup in the pace of new debt sales in the fourth quarter. The Municipal Market Data (MMD) One-Year Note Index rose 14 basis points in September to 1.30%. We continue to maintain our emphasis on high levels of liquidity and relatively short duration as we monitor how monetary policy unfolds.

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

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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

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