Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Funds (UK)

Sterling Corporate Bond Fund

GLOBAL FIXED INCOME | GLOBAL FIXED INCOME TEAM | MONTHLY COMMENTARY | 30 APRIL 2019

Performance Review

In the one month period ending 30 April 2019, the Fund's I ACC shares returned 0.51% (net of fees)[1], while the benchmark returned -0.18%.

Sterling investment grade (IG) credit spreads ended the month 12 basis points (bps) tighter. The overweight to IG corporates added to performance, which was partially offset by a small negative contribution from government-related bonds. Financials were the largest contributor (18 bps) followed by industrials (17 bps), while utilities added 1 bp due to their more defensive nature. The overweight to high yield also added to performance.

The U.K. 10-year gilt ended the month 19 bps higher at 1.19% and the 5-year gilt was 15 bps higher at 0.91%. The portfolio is positioned to be underweight duration, which had a positive impact on performance as yields were higher across the curve.

Market Review

April was a positive month for fixed income assets. Federal Reserve (Fed) and European Central Bank (ECB) patient stances at the end of March paved the way for increased investor confidence across the globe in April. This was reinforced by additional accommodative statements by central banks in Australia, Canada and Japan in April, while the ECB mentioned it will provide further guidance on the new targeted longer-term refinancing operation (TLTRO) and deposit tiering system in June. The U.S. economy surprised to the upside, posting a +3.2% first quarter 2019 gross domestic product (GDP) annualized growth rate, which led U.S. Treasuries 5 bps and 10 bps higher on the 5- and 10-year maturities, respectively. Reduced concerns over global growth on the back of an improving Chinese economy and U.S.-China trade talks also favoured risk assets and helped sentiment during the month. However, the positive spill-over to the European economy has not materialized in macro data yet. German 10-year bund yields were 8 bps higher in April. Concerns over fiscal policy were the dominant themes in France and Italy. The former announced expansionary measures which are likely to stretch the fiscal budget, and the latter began to face rising concerns of triggering a value added tax increase later in the year, despite a return to positive GDP growth in the first quarter and the avoidance of a downgrade by S&P. French 10-year OAT yields were 5 bps higher, while Italian 10-year BTPs yields were 7 bps higher during the month. Peripherals' spreads saw Greece and Portugal outperforming Spain (10-year yields closed the month 37, 14 and 10 bps lower, respectively). The European Union (EU) granted a Brexit extension until 31 October, partially relieving concerns over a hard Brexit and pushing U.K. gilt yields 19 bps higher. Equity and commodity markets had positive performance globally, as the S&P 500 Index closed the month up 4.05% on a total return basis and West Texas Intermediate crude up 6.27%, while the VIX index further declined to the 13 level.

In April, we saw continued strength in spread products globally, as credit benefitted from the pickup in the abovementioned macro trends, namely the pickup in the Chinese economy and the continued accommodative stances from global central banks. The final outcome of the U.S.-China trade talks and the expected pickup in European economic growth in Europe in the second half of the year remain the main catalysts for risk assets globally. We saw strong spread tightening across the globe, with no major differences across sectors. Sterling IG credit was 12 bps tighter, closing at 144 bps. EU IG credit was the best performer in April, closing the month 15 bps tighter at 107 bps. Globally, the BBB rating bucket outperformed higher-quality credit, as investors' appetite for risk increased over the month. Primary issuance was light in April globally, due to market quietness around Easter break. Sterling IG issuance amounted at £4.1 billion. Year-to-date, 31% of sterling issuance has been in the 7- to 10-year part of the curve, versus an historical average of just 8%. Europe IG issuance totalled €38.2 billion in April, with financials accounting for two-thirds of the total.

While Brexit headlines have become few and far between, the EU granted the U.K. an extension on Article 50 until Halloween at its summit on 10 April. The European Council is giving the U.K. the ultimate power to decide what happens from here – as the U.K. could completely 'cancel' Brexit if it desired. The next significant date in the Brexit saga is the June 30 review of the U.K.'s progress.

[1] Source: Morgan Stanley Investment Management Limited. Data as of 30 April 2019.

In Europe, economic data was mixed, although euro area growth saw its strongest reading in three quarters. The ECB met in the middle of the month and kept rates on hold, as expected, and pushed back expectations of a rate hike to 'the end of 2019'. ECB President Mario Draghi stated that the bank is ready to utilize 'all available instruments' if the economic landscape deteriorates further in the eurozone. Draghi reiterated that the balance of risks to the eurozone remains 'tilted to the downside', citing Brexit and trade issues as two specific risks plaguing the region.

The Bank of Japan (BOJ) also met in April and kept rates on hold as well. The bank stated that it expects interest rates to stay at current levels through at least spring of 2020. The BOJ also slightly adjusted its forecasts amid stubbornly below-target inflation data.

In the U.S., Treasury Secretary Steven Mnuchin said that U.S.-China trade talks are 'in the final laps', implying that he believes that an agreement is imminent. Two areas that remain in contention are whether the U.S. will lift current tariffs and how the U.S. will enforce Beijing's 'trade abuses'.

Portfolio Activity

There were no material changes to the portfolio during the month.

Strategy and Outlook

Strategy:

We increased our underweight credit in spread duration terms but remain overweight in some of the higher-beta credit (thus long credit on an option-adjusted spread-to-yield basis). We still favour financials (particularly subordinated names) and industrials; however, we remain selective in this sector, as valuations become tighter and the risks of shareholder-friendly (i.e. merger and acquisition) activities persist. In terms of interest rate risk, we remain underweight in duration terms, which we expect to generate positive alpha should gilt yields rise on the back of receding chances of a no-deal Brexit. We also continue to look for new issues to take advantage of new opportunities in the primary market.

Outlook:

Easy monetary policy, economic data that is both not too hot nor too cold, decent corporate earnings and strong demand for credit are all supportive for the markets looking forward. However, while the backdrop is broadly supportive, valuations are no longer as cheap with spreads now sitting below long-run averages. With spread levels no longer exceptional, we continue to de-risk most portfolios by reducing higher beta exposures such as BBBs, high yield and convertible bonds. We still find credit attractive given the rather benign macro backdrop, but we believe the bulk of capital gains for the year is behind us. Further tightening will require risk sentiment to remain high and volatility to remain low. As such our base case is for the asset class to generate the majority of future excess returns from carry and rolling down the yield curve as opposed to aggressive spread tightening. Technicals have been strong, but new issue supply is likely to pick up in May, hopefully providing for some attractive investment opportunities. As we've been saying for some time, sector and issuer selection remains a focus as technology and behavioural change are both fast moving and disruptive for many traditional industry business models. These concerns, coupled with absolute valuations, will keep us more tactical with our additions and subtractions of risk in the months ahead.

U.S. growth is likely to be lower for the remainder of 2019 as the fiscal impulse wears off and the lagged effect of higher rates bite, but not collapse. Central banks have become more accommodative, and we expect that to continue.

Recent speeches from the Fed policymakers give us further confidence that the Fed is committed to being 'patient' and 'flexible' regarding future rate hikes. With that being said, at this point it is not likely the Fed will hike rates again in 2019. The Fed wants to contain inflation risk; it does not want to cause a hard landing/recession. It is therefore likely that the peak in the U.S. Treasury 10-year yield is likely to be below 3.0% and the low likely above 2.3%. In the shorter term, we believe that the U.S. 10-Year Treasury yield is likely to spend a majority of the time between 2.35% and 2.65% for the next several months.

BOJ policy will remain easy along with other central bank policies such as the Fed and ECB, but the BOJ may be uncomfortable with 10-year Japanese government bond (JGB) yields falling below -0.10%. It may alter policy to ensure yields don't dip below that level. It is likely that 10-year JGBs will be in a -0.10% to 0.10% range.

In the eurozone, the ECB has stepped away from its previous hawkish policy and has eliminated the first rate hike call from the fourth quarter of 2019 to an unspecified time in the future. The ECB claims it could be some time in 2020, but the market has priced out a rate hike from the ECB indefinitely.

In terms of currencies, we expect the U.S. dollar to weaken modestly at some point. The timing is likely to depend more on developments outside the U.S. than inside. In the year ahead, we expect the Fed policy cycle to peak at 2.5% and U.S. growth rates to weaken. With the peak in both growth and rates behind us, the U.S. dollar may readjust to lower levels. Ultimately, we see market uncertainty revolving around whether or not the end, or pause, of the Fed tightening cycle will produce a soft, bumpy or hard landing; and whether or not China's stimulus policies enacted in 2018 will help stabilize its economy in 2019. Additional considerations reside with Europe and Brexit – political risks that are difficult to value.

For further information, please contact your Morgan Stanley Investment Management representative.

FUND FACTS

Launch date	Base currency	Index
11 December 2000	Sterling	ICE BofAML Sterling Non-Gilt Index

12 Month Performance Periods to Latest Month End (%)

	APRIL '18 - APRIL '19	APRIL '17 - APRIL '18	APRIL '16 - APRIL '17	APRIL '15 - APRIL '16	APRIL '14 - APRIL '15
OEIC Sterling Corporate Bond Fund - I ACC Shares	2.96	1.81	8.70	1.71	8.59
ICE BofAML Sterling Non-Gilt Index	3.60	0.70	9.66	2.59	9.88

Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. All performance data is calculated NAV to NAV, net of fees, and does not take account of commissions and costs incurred on the issue and redemption of units. The sources for all performance and Index data is Morgan Stanley Investment Management. **Please visit our website www.morganstanley.com/im to see the latest performance returns for the fund's other share classes.**

The Blended Index performance shown is calculated using the ICE BofAML STG non-gilt all stocks 10yr+ Index from inception through 3 November 2003 and the ICE BofAML Sterling Non-Gilt Index thereafter.

Share Class I ACC Risk and Reward Profile

Lower Risk **Higher Risk**

1 2 **3** 4 5 6 7

Potentially Lower Rewards **Potentially Higher Rewards**

The risk and reward category shown is based on historic data.

- Historic figures are only a guide and may not be a reliable indicator of what may happen in the future.
- As such this category may change in the future.
- The higher the category, the greater the potential reward, but also the greater the risk of losing the investment. Category 1 does not indicate a risk free investment.
- The fund is in this category because it invests in fixed interest securities and the fund's simulated and/or realised return has experienced medium rises and falls historically.
- The fund may be impacted by movements in the exchange rates between the fund's currency and the currencies of the fund's investments.

This rating does not take into account other risk factors which should be considered before investing, these include:

- The value of bonds are likely to decrease if interest rates rise and vice versa.
- The value of financial derivative instruments are highly sensitive and may result in losses in excess of the amount invested by the Sub-Fund.
- Issuers may not be able to repay their debts, if this happens the value of your investment will decrease. This risk is higher where the fund invests in a bond with a lower credit rating.
- The fund relies on other parties to fulfill certain services, investments or transactions. If these parties become insolvent, it may expose the fund to financial loss.
- There may be an insufficient number of buyers or sellers which may affect the fund's ability to buy or sell securities.
- Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. The value of investments and the income from them can go down as well as up and investors may lose all or a substantial portion of his or her investment.
- The value of the investments and the income from them will vary and there can be no assurance that the Fund will achieve its investment objectives.
- Investments may be in a variety of currencies and therefore changes in rates of exchange between currencies may cause the value of investments to decrease or increase. Furthermore, the value of investments may be adversely affected by fluctuations in exchange rates between the investor's reference currency and the base currency of the investments.

Please refer to the Prospectus for full risk disclosures. All data as of 30 April 2019 and subject to change daily.

INDEX INFORMATION

The **ICE BofAML Sterling non-gilt all stocks 10yr+ Index** tracks the performance of GBP denominated investment grade non-sovereign debt publicly issued in the eurobond or U.K. domestic market with a 10 year or longer maturity.

The **ICE BofAML Sterling Non-Gilt Index:** tracks the performance of GBP denominated investment grade non-sovereign debt publicly issued in the eurobond or UK domestic market, including quasi-government, corporate, securitized and collateralized securities. Defaulted securities are excluded from the Index.

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

The **Volatility Index (VIX)** is the ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options. It represents one measure of the market's expectation of stock market volatility over the next 30-day period. The VIX is quoted in percentage points and translates, roughly, to the expected movement in the S&P 500 index over the next 30-day period, which is then annualized.

West Texas Intermediate (WTI), also known as Texas light sweet, is a grade of crude oil used as a benchmark in oil pricing. It is the underlying commodity of Chicago Mercantile Exchange's oil futures contracts.

IMPORTANT INFORMATION

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