Morgan Stanley Funds (UK)

Sterling Corporate Bond Fund

BROAD MARKETS FIXED INCOME TEAM

Performance Review

In the one month period ending 30 June 2024, the Fund's I ACC shares returned 1.17% (net of fees)[1], while the benchmark returned 0.87%.

The performance can be attributed to the following factors.

The portfolio's overall investment grade credit positioning had a negative impact on performance.

The portfolio is positioned to be overweight financials and overweight industrials when measured in duration times spread terms.

Positions within investment grade financials were drivers of negative performance, due to the overweight to banking and insurance. However, underweight positions to other financials had a marginally positive contribution.

Moreover, positions within investment grade industrials were also drivers of negative performance, as a result of the overweights to energy, consumer cyclical and consumer non-cyclical.

Positions within investment grade utility had a negative impact on performance, particularly because of the overweight to electric.

The overweight in high yield positions and government-related positions each had a slightly negative impact on performance.

Overall, duration positioning had a small positive impact on performance.

Market Review

June continued the recent roller-coaster performance in fixed income. Government bonds continued to rally as economic data, particularly inflation in the U.S., renewed its downward trajectory and re-invigorated the "soft landing" thesis that the Federal Reserve (Fed) would cut rates more than once this year and multiple times next year. A "soft landing" is an economy experiencing falling inflation, lower policy rates and trend-like growth, with only modest upward pressure on unemployment rates. This scenario is quite positive for fixed income, in general, but particularly for spread sectors like corporate and securitised credit. In the U.S., both the consumer and producer price inflation prints were softer than expected. In the euro area, although inflation readings were largely in line with market projections, it led to markets pricing in more monetary support from the European Central Bank (ECB).

In June, European investment grade credit spreads widened driven by wider swap spreads, while government bond yields rallied. Market sentiment was dominated by several factors. Firstly, European and French assets re-priced wider (the France-Germany government bond spread widened to multi-year highs) following Macron's call for snap elections and reflecting the market's concerns about the fiscal and geopolitical implications. Secondly, European composite purchasing managers' index (PMI) data came in softer than expected but remains in expansionary territory. In the U.S., data came in softer than expected as the ISM Manufacturing PMI moved further into contractionary territory. Thirdly, the ECB joined the Swiss National Bank and Sweden's Riksbank in cutting policy rates by 25 basis points (bps), with communication avoiding pre-committing to a particular rate path. Finally, primary issuance in June was in line with expectation. New issue order books remained robust, but investors demanded bigger new issue premiums against a backdrop of higher volatility.

Portfolio Activity

No significant changes to note.

Strategy and Outlook

Strategy

The portfolio is broadly neutral credit in spread duration terms, while remaining overweight in some of the higher-beta credit. We still favour financials (particularly subordinated names) and industrials overall; however, we remain selective in this sector, and the risks of shareholder-friendly (i.e., merger and acquisition) activities persist. In terms of interest rate risk, we are broadly neutral versus the benchmark in duration terms. We also continue to look for new issues to take advantage of new opportunities in the primary market.

Outlook

Looking at the second half of the year, there is no doubt that markets are now on rate-cut watch. Outside of Australia and Japan, no central banks are considering raising rates. After rate cuts from Switzerland (more than one), Sweden, Canada and the ECB, it is only a matter of time before we see more. The questions are how long we have to wait and how deep those cuts will be. Despite central

[1] Source: Morgan Stanley Investment Management Limited. Data as of 30 June 2024.

bank reticence to jump on the rate-cutting train, bond investors have become optimistic about future Fed policy and are now forecasting up to two Fed rate cuts in 2024, when, as of earlier this year, there was less than one expected. The current outlook is that rate cuts will happen, just not yet. In addition to monetary policy uncertainty, the outlook for bonds has become clouded by politics. It is possible that political change could usher in meaningfully different economic policies, which could have a material impact on yields and/or spreads. The situation warrants monitoring, so we have become more cautious and are adopting a wait-and-see posture.

Looking forward our base case remains constructive for credit, supported by expectations of a "soft landing", fiscal policy that remains supportive of growth/employment/consumption, and strong corporate fundamentals. Lighter gross issuance in the second half of 2024 coupled with strong demand for the "all-in" yield offered by investment grade credit are expected to create a supportive technical dynamic. Finally, the uncertainty and outcome of the French parliamentary elections are expected to drive near-term sentiment for credit markets. When looking at credit spreads, we view the market as close to fairly priced and therefore see carry as the main driver of return, with the potential for a reversal in some of the spread widening seen in June if we see a positive election outcome in France. Given the uncertain medium-term fundamental backdrop, we have less confidence in material spread tightening.

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

Fund Facts

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

12 Month Performance Periods to Latest Month End (%)

	JUNE '23 - JUNE '24	JUNE '22 - JUNE '23	JUNE '21 - JUNE '22	JUNE '20 - JUNE '21	JUNE '19 - JUNE '20
OEIC Sterling Corporate Bond Fund - I ACC Shares	12.03	-4.53	-14.52	4.27	4.61
ICE BofA Sterling Non-Gilt Index	9.70	-7.10	-12.90	1.85	6.45

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.**

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 can be complex and volatile, 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.
- Sustainability factors can pose risks to investments, for example: impact asset values and increased operational costs.
- 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 June 2024 and subject to change daily.

INDEX INFORMATION

The **ICE BofA 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 Index has been selected as a target benchmark because it is representative of the type of bonds in which the Fund is likely to invest, and it is therefore an appropriate target for the Fund's performance.

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