Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Funds (UK)

Sustainable Fixed Income Opportunities Fund

MULTI-SECTOR TEAM | MONTHLY COMMENTARY | 30 APRIL 2023

Performance Review

In the one month period ending 30 April 2023, the Fund's I ACC shares returned 0.54% (net of fees)[1].

The Fund had positive absolute performance in April.

Within rates, the overall impact of duration positioning on performance was positive, mainly due to the allocation to U.S. dollar rates as yields fell broadly across the market.

Within credit, euro investment grade corporate spreads tightened -7 basis points (bps) to +162 bps over the month (-5 bps year-to-date). U.S. investment grade corporate spreads underperformed as they tightened -2 bps to +136 bps (+6 bps year-to-date). Therefore, the portfolio's allocation to investment grade credit outperformed, with the financials (banking) allocation contributing the most. Financials outperformed industrials and utilities.

Similarly, the Fund's exposure to high yield credit contributed to returns, especially the exposure to utility.

Elsewhere, the exposures to treasuries and securitised debt both contributed.

There were no material detractors from relative performance this month.

Market Review

Developed market rates were mixed in April, with yields largely moving sideways in most economies and U.S. yields falling slightly. As volatility declined slightly following March's banking sector stress, the market shifted to interpreting new economic data and predicting the prospect and significance of a credit crunch. In the U.S., while the labour market data, employment cost index (ECI) and personal consumption expenditures (PCE) inflation data came in stronger than expected, Institute for Supply Management (ISM) manufacturing data and Job Openings and Labor Turnover Survey (JOLTS) data came in weaker than expected. Elsewhere, in New Zealand, yields fell as consumer price index (CPI) data came in softer than expected, while in contrast, yields in the U.K. rose on the back of stronger inflation data. In terms of central bank meetings, the Reserve Bank of New Zealand surprised markets when it hiked by 50 bps versus the 25 bps expected. The Reserve Bank of Australia and Bank of Canada kept rates the same, in line with expectations. The Riksbank raised rates by 50 bps, as anticipated. Finally, the Bank of Japan, in Ueda's first meeting as governor, kept the policy the same, including the yield curve control policy.

European investment grade spreads outperformed U.S. investment grade spreads this month amid elevated credit market volatility driven by several aforementioned factors. Main themes included U.S. bank volatility and weaker U.S. economic data. European data remained more robust, reflecting the reduced impact of supply chain disruption and the continued support of fiscal programmes like the European Recovery Fund. Similarly, global labour markets remain strong, supporting consumption and labour price inflation and leading to continued rate hike expectations/tighter monetary policy. First quarter reporting mostly outperformed expectations, with financials benefiting from higher net interest margins, while non-financials highlighted continued pricing power, the benefits of reopening (airlines) and the impact of prior cost-cutting (cyclicals).

Volatility in the U.S. and global high yield markets receded in April, and the demand for credit risk generally improved amid lacklustre secondary trading volume and renewed capital markets activity. Investors took advantage of still historically attractive yields, and the higher-beta segments of the high yield market generally outperformed.

After the volatility and spread widening in March, the securitised markets stabilised in April, although spreads remain materially wider over the past two months. We continue to believe that the fundamental credit conditions of residential housing loan markets remain sound, but we also believe that higher risk premiums are warranted across all credit assets given projected economic weakness.

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[1] Source: Morgan Stanley Investment Management Limited. Data as of 30 April 2023.

Emerging markets debt delivered positive returns for the month. Many emerging markets currencies strengthened during the month. Spreads tightened in emerging market corporates and were flat in hard currency sovereigns, but the rally in U.S. Treasury yields contributed to performance.

Portfolio Activity

In April, the Fund's duration decreased to 3.61 years, with most of the change expressed through a decrease in exposure to developed market rates (especially U.S. dollar and U.K. sterling). Elsewhere, we trimmed exposure to investment grade corporates.

The Fund has an exposure to green bonds and social, sustainability and sustainability-linked bonds of 20.5%.

Strategy and Outlook

While the acute stress from the banking sector issues has lessened, the problems have not fully gone away and will continue to impact the economy. Despite the lack of clarity regarding the magnitude of the economic impact, credit conditions are likely to tighten even further. The market is pricing scenarios where the Federal Reserve (Fed) goes much higher (i.e., taking rates to 5.75%-6%), as well as pricing in a greater likelihood of a recession. Unfortunately for the Fed, while the banking issues will likely be disinflationary, CPI, ECI and PCE data again confirmed that inflation and wages are still elevated and sticky. Given the uncertainty, it is difficult to concretely express an outright view on interest rates, and it may be wise to be patient for now, awaiting further clarification while taking advantage of more relative dislocations. In terms of foreign exchange, coming into this situation, we thought the U.S. dollar could weaken, which it has continued to do. We still believe that dollar weakness could continue.

For investment grade credit, our base case view remains that we are compensated to own credit as we view corporate fundamentals to be resilient and the macro backdrop to likely improve as monetary policy tightening pauses and China reopens. We view companies as having built liquidity in recent quarters and implemented cost-efficiencies under the COVID era. We expect profit margins to be pressured by increased costs (although first quarter reporting suggests companies are protecting margins in the short term) and top-line revenue to be challenging, but given the starting point we believe corporates will be able to manage a slowdown without significant downgrades or defaults (base case: low default and low growth). Supportive for the investment grade credit market is demand for high quality fixed income assets at absolute yields not seen for a number of years.

We remain cautious on the high yield market as we progress through the second quarter of 2023. Episodic weakness accompanied by volatile spread movement seems to be the most likely path forward due to several factors, starting with clear evidence of existing cracks in the U.S. economy and what we view as the increasing likelihood of a hard economic landing.

In securitised markets, we remain concerned about global economic conditions, and we expect employment rates to decline and households to experience greater stress. We expect home prices to fall another 5%-10% for the remainder of 2023. U.S. residential credit remains our favourite sector, and we remain more cautious of commercial real estate, especially office, which continues to be negatively impacted in the post-pandemic world.

We remain constructive on emerging market debt, despite the fact the volatility stemming from banking stresses in developed markets has put a damper on the macro picture to some degree. Growth, inflation and policy are quite differentiated among countries and credits within the emerging markets universe, so bottom-up analysis is critical to uncover value.

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

FUND FACTS

Launch date	Base currency
11 December 2020	Sterling

12 Month Performance Periods to Latest Month End (%)

	APRIL '22 - APRIL '23	APRIL '21 - APRIL '22	APRIL '20 - APRIL '21	APRIL '19 - APRIL '20	APRIL '18 - APRIL '19
OEIC Sustainable Fixed Income Opportunities Fund - I ACC Shares	-1.60	-4.53	--	--	--

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.
- Investment in China A-Shares via Shanghai-Hong Kong Stock Connect program may also entail additional risks, such as risks linked to the ownership of shares.
- There are increased risks of investing in emerging markets as political, legal and operational systems may be less developed than in developed markets.
- 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 2023 and subject to change daily.

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