Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Investment Funds

# Emerging Markets Domestic Debt Fund

**GLOBAL FIXED INCOME TEAM** | MONTHLY COMMENTARY | 30 SEPTEMBER 2021

## Important information

• The Fund invests primarily in a portfolio of emerging market bonds and other emerging market debt securities, denominated in the local currency of issue.
• Investment involves risks. Key risks for this fund include Emerging Market Risk, Emerging Market Currency Risk, Exchange Rate Risk, Interest Rate Risk, Credit Risk, Derivatives Risk, Downgrading Risk, Unrated Securities Risk, Risk of Exposure to the Euro and Eurozone and Risk of Discretionary Distributing Share Class.
• The Fund may pay distributions out of capital. Payment of dividends out of capital amounts to a return or withdrawal of part of a Shareholder's original investment or from any capital gains attributable to that original investment. Any distribution involving payment of dividends out of capital may result in an immediate decrease of the NAV per share.
• There is a risk that you may potentially lose your entire investment in this Fund.
• The investment decision is yours but you should not invest unless the intermediary who sells it to you has advised you that it is suitable for you and has explained why, including how buying it would be consistent with your investment objectives. You should not make any investment decision solely based on this document. Please read the relevant offering document carefully for further fund details including risk factors.
• The Fund may use derivatives for investment or efficient portfolio management (including hedging) purposes which may expose to higher counterparty, liquidity and valuation risks. The Fund may suffer losses from its derivatives usage.

## Performance Review

In the one month period up until 30 September 2021, the Fund's A shares returned -3.47% (net of fees)[1], while the benchmark returned -3.43%.

### Contributors to Relative Performance

- Overweight to Zambian kwacha and Dominican peso.
- Security selection in Chile and Peru.

### Detractors from Relative Performance

- Overweight to Egyptian pound.
- Security selection in Mexico and South Africa.

## Market Review

U.S. rates rose in September, with the U.S. 10-year Treasury closing the month 18 basis points (bps) higher at 1.49%. The U.S. dollar strengthened relative to other major currencies, oil prices rallied and equity markets dropped amid a challenging global macro backdrop for emerging markets (EM).

EM debt returns were negative in September. Hard currency sovereigns (proxied by the J.P. Morgan EMBI Global Diversified Index) returned -2.1%, driven by wider spreads and yields. EM corporate returns were also negative for the month, returning -0.7%, according to the J.P. Morgan CEMBI Broad Diversified Index, with high yield (-0.7%) underperforming investment grade corporates (-0.6%). Local currency bonds (proxied by the J.P. Morgan GBI-EM Global Diversified Index) posted negative returns (-3.4%), primarily due to weaker EM currencies versus the U.S. dollar (-2.3%). From a broad market perspective, Lebanon, Belize, Venezuela, Belarus and Iraq were the best performers in September, while bonds from El Salvador, Ecuador and Argentina were laggards. From a sector perspective, infrastructure, financials, utilities and transport companies led the market, while those in the real estate, pulp & paper and consumer sectors lagged.

In Latin America, central banks continued tightening monetary policy to contain inflation, with Colombia seeing its first interest rate change in a year as it increased its lending rate by 25 bps to 2.0%. The Central Bank of Chile delivered a hawkish surprise, hiking its policy rate by 75 bps to 1.50% (vs. 1.25% consensus), citing overheating concerns. The Central Reserve Bank of Peru increased its

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[1] Source: Morgan Stanley Investment Management Limited. Data as of 30 September 2021.

benchmark rate by 50 bps to 1.0%, in line with market expectations, while adding that the decision did not necessarily imply the beginning of a hiking cycle. In Brazil, the central bank increased its policy rate by 100 bps to 6.25% as inflation continued to rise. For the next meeting, the board foresees another hike of the same magnitude. The Bank of Mexico also hiked its policy rate, by 25 bps to 4.75%, as expected, and raised its consumer price index inflation forecasts. Elsewhere in the region, primary elections in Argentina delivered a crushing blow to the ruling Peronist party, on the back of a severe economic crisis and a botched COVID-19 government response. Confirmation of these results at the November midterm elections may limit the scope of further policy radicalization in the medium term, though the immediate impact is less certain as governability may be compromised due to a weaker ruling coalition.

In Asia, Bank Negara Malaysia maintained its policy rate at 1.75% at its latest meeting, with the statement containing a more benign assessment of activity, driven by a fast pace of vaccination that could lead to a reopening of the economy in the months ahead. Bank Indonesia kept its policy rate unchanged at 3.50%, as it considers its current monetary stance as growth-supportive and consistent with currency stability. Despite inflation running above target, the Central Bank of the Philippines also remained on hold, arguing that high inflation prints are temporary and do not require tighter monetary policy. In China, the central bank continued to pump short-term liquidity into the financial system to calm the market, which was rattled by missed coupon payments by property developer Evergrande (the second-largest developer in the country, with $300 billion worth of debt) and potential contagion effects into other sectors of the Chinese economy. The People's Bank of China has added a total net 750 billion yuan via open market operations since mid-September, driving down the overnight interbank funding costs to the lowest level since May. Finally, the Bank of Thailand (BoT) voted unanimously to keep its policy rate unchanged at 0.50%. Such unanimous consensus suggests that the scope for further easing is limited, as the BoT now shifts focus to a weakening Thai baht.

In Europe, the Czech National Bank hiked the policy rate by 75 bps to 1.5%, exceeding market expectations (50 bps) and sending a hawkish message amid elevated inflation. In Poland, the central bank kept the policy rate unchanged at 0.1%, and the governor reiterated a dovish stance, highlighting the November forecasts as key for the policy outlook. In Hungary, the central bank hiked the policy rate by 15 bps to 1.65%, which was at the lower end of market expectations. Policymakers reaffirmed their hawkish forward guidance and announced a reduction in liquidity measures. In Turkey, the central bank unexpectedly cut the policy rate by 100 bps to 18%, despite elevated inflation and risks to financial stability. The premature monetary easing has put pressure on Turkish assets. Elsewhere in Europe, the Central Bank of Russia hiked its policy rate by 25 bps to 6.75%, a less hawkish outcome relative to market expectations for a 50 bp increase. The post-meeting statement preserved its hawkish tone, citing the possibility of further hikes on the back of still-high inflation expectations. Finally, the European Commission decided to disburse the second tranche of macro-financial assistance to Ukraine for a total of €600 million. In addition, the Ukrainian government expressed optimism about upcoming negotiations with the International Monetary Fund over the stalled standby agreement program, expecting to receive $750 million by year-end.

In Africa, the South African Reserve Bank kept its policy rate at 3.5%, in line with consensus. The statement was slightly more hawkish as inflation risks are tilted to the upside, with risks coming from a weaker currency as well as higher food, oil and electricity prices.

## Portfolio Activity

During the month, we reduced Hungary from overweight to neutral, taking profits on less compelling valuations. We also reduced Indonesia to duration neutral to take profit, as local bonds have outperformed. Meanwhile, we added exposure to Poland, China and the Czech Republic.

## Strategy and Outlook

The outlook for EM debt in the weeks ahead looks challenging, as the asset class faces multiple disruptive forces. The prospects of Federal Reserve tapering as early as November and its impact on real yields and the U.S. dollar may weigh on EM asset performance. A strengthening dollar is even more challenging in the current scenario, where EM growth has so far failed to catch up with that of advanced economies and inflationary pressures remain at large (mainly due to supply-side disruptions), forcing a global tightening of monetary conditions. Moreover, recent negative headlines about China's real estate market, besides contributing to deteriorating market sentiment, imply a weakening Chinese economy in the quarters ahead, which could adversely impact commodity exporters in the EM universe (except oil, which seems to be well supported due to supply-side factors). Therefore, we remain cautious on risk in the near term, despite valuations being generally attractive. We are biased toward EM high yield credits with positive idiosyncratic stories and/or exposure to higher oil prices (and similarly, in EM currencies). In rates, we prefer yield curves that are already pricing in aggressive monetary policy tightening.

Despite this near-term unconstructive backdrop, there are potential developments that could revive optimism toward the asset class. These include an effective response by Chinese authorities to the crisis in the real estate market, as well as any further policy easing that could mitigate the negative impact on Chinese growth. In addition, an easing of supply bottlenecks could also provide a respite to rising inflationary pressures globally, reducing the need for tighter monetary policy. This could also be facilitated by higher COVID-19 vaccination rates globally, which are allowing many countries in the EM world to reopen their economies (most recently in selected countries in Asia and Latin America), thus supporting the supply response. Finally, domestic politics – such as midterm elections in Argentina, presidential elections in Chile, and policy changes by new administrations in Peru, Malaysia and Zambia – could deliver both negative and positive surprises.

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

**FUND FACTS**

| Launch date | Base currency | Index |
|---|---|---|
| 28 February 2007 | U.S. dollars | JPM GBI - EM Global Diversified Index |

**12 Month Performance Periods to Latest Month End (%), Presented in USD Terms**

| | SEPTEMBER '20 - SEPTEMBER '21 | SEPTEMBER '19 - SEPTEMBER '20 | SEPTEMBER '18 - SEPTEMBER '19 | SEPTEMBER '17 - SEPTEMBER '18 | SEPTEMBER '16 - SEPTEMBER '17 |
|---|---|---|---|---|---|
| MS INVF Emerging Markets Domestic Debt Fund - A Shares | 2.32 | -2.83 | 9.63 | -10.08 | 5.77 |
| JPM GBI - EM Global Diversified Index | 2.63 | -1.45 | 10.13 | -7.40 | 7.32 |

**Investment involves risks. 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 and assume the reinvestment of all dividends and income. The sources for all performance and Index data is Morgan Stanley Investment Management. **Please refer to the relevant offering documents for fund details, including risk factors.**

**INDEX INFORMATION**

**JP Morgan GBI-EM Global Diversified Index**: a comprehensive global local emerging markets index that consists of regularly traded, liquid fixed-rate, domestic currency government bonds and includes only the countries which give access to their capital market to foreign investors (excludes China, India). The index is market capitalization weighted, with a cap of 10% to any one country.

The **JP Morgan CEMBI Broad Diversified Index** is a global, liquid corporate emerging-markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging-markets entities.

The **JP Morgan Emerging Markets Bond Global Index** tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the EMBI+. As with the EMBI+, the EMBI Global includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million.

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