Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Investment Funds

Global Bond Fund

GLOBAL FIXED INCOME TEAM | MONTHLY COMMENTARY | 31 OCTOBER 2021

Important information

• The Fund invests primarily in domestic, international and Euromarket fixed income securities of varying maturities denominated in US Dollars and other currencies, including emerging markets.
• Investment involves risks. Key risks for this fund include Interest Rate Risk, Credit Risk, High Yield Securities Risk, Exchange Rate Risk, Emerging Market Currency Risk, Derivatives Risk, Downgrading Risk, Unrated Securities Risk and Risk of Exposure to the Euro and Eurozone.
• 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 ending 31 October 2021, the Fund's A shares returned -0.23% (net of fees)[1], while the benchmark returned -0.24%.

Market Review

A key question hanging over financial markets is: how hard will central banks push back against inflation? Inflation has continually surprised to the upside, even if it is no longer surging higher in year-on-year terms. Developed market central banks had until recently remained calm, accepting that most of the shock was likely transitory due to supply chain and labor market disruptions, and large shifts in aggregate demand to goods from services. Being unusually sanguine, they talked dovishly, remained focused on downside risks and hoped it would sort itself out before transitory morphed into troubling.

No more. Bond markets, but surprisingly not equity markets, were rocked in October by hawkish shifts in central bank policy and rhetoric, and aggressive repricing of rate expectations. The era of central bank passivity has come to a close, and policy normalization has begun. First, the Norwegian central bank raised rates in September. Removing accommodation that was no longer needed was the justification. Then two weeks later in early October, the New Zealand central bank raised rates in a more hawkish fashion, meaning this was the first of potentially many rate hikes. The initial view was they're small countries and markets did not think they mattered too much. But then the Bank of Canada on 27 October suddenly, seemingly out of the blue, ended quantitative easing (QE) and announced rates would likely be hiked mid-2022, almost a year sooner than expected. This was compounded by credible talk from the Bank of England that it would raise rates in November, and the Australian central bank failed to defend its yield curve control policy, sending yields up 62 basis points (bps) in three days! This, in a country where the central bank has adamantly insisted rates would not rise at all until 2024! Of course, it did not help that the Fed was meeting in the first week of November where it was highly likely to confirm (which it did) ending its emergency QE programs, which sent U.S. short-maturity yields significantly higher.

What to make of all this? Normalization is the new mantra. The need for emergency levels of accommodation is broadly thought to be no longer necessary, especially with growth above trend in 2021-22 and inflation proving to be potentially more than transitory. However, normalization is not tightening. It is removing unnecessary accommodation and getting policy back to a more neutral setting. As such, for most countries, like the U.K., eurozone, Canada and most importantly the U.S., we should not expect their central banks to tighten policy aggressively; they are more likely to take a more leisurely approach to policy adjustments than the market currently expects. In the case of Australia, if the Reserve Bank is any good at forecasting its own policy, interest rates have well overshot. Emerging markets are another story, with significant hikes occurring and no end in sight as inflation has become even more intransigent in countries like Poland, Czech Republic, Russia, Mexico and Brazil. As such, EM local markets have had a horrid

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1 Source: Morgan Stanley Investment Management Limited. Data as of 31 October 2021.

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time as monetary policy tightenings have been big and unrelenting (and, as of yet, with no letup in inflation pressures).

Therefore, we expect developed market central banks to proceed slowly and with caution – and, yes, monetary policy angst is overdone. But this could still lead to volatility in markets, depending on what investors expect. Markets initially aggressively priced the beginning of rate hiking cycles, much more than most central banks thought appropriate. Indeed, the most egregious sell-offs in the front ends of yield curves are already correcting themselves. We expect the total amount of tightening to remain modest as, again, most developed market central banks do not want restrictive policies: they simply want less accommodative policies. However, if investors (or central banks) change their mind on this, for example because higher inflation appears to become more entrenched and the economy remains resilient, bond yields might need to rise considerably. In credit markets, spreads are still below long-term averages despite recent volatility; this seems justified given the benign economic outlook and stronger corporate and household balance sheets, but even a minor deterioration in credit conditions could impact valuations. Of course, the "central bank put" could still come into play, with tightening measures delayed or canceled if markets wobble too much, but the pace of normalization will primarily depend on the state of the economy.

In terms of our market views, we have generally been reducing portfolio risk given the uncertain outlook. We remain long risky assets (corporate credit, securitized credit, emerging markets) because of the positive economic outlook and strong fundamentals, and in spite of credit spreads being tight relative to history. We expect government bond yields to drift higher as we move towards tighter monetary policy, but it will be a "long and winding road".

Strategy and Outlook

October was an extraordinary month in terms of bond market volatility. While longer-maturity yields remained well anchored, short-maturity yields skyrocketed as central banks began to reduce accommodation. Through the first half of the month, longer-maturity yields generally rose as anxiety rose about inflation. Transitory was not turning out to be so transitory. And even if it were transitory, it had risen so high that, even if it came down substantially, it would still be too high for policy maker's comfort at the end of 2022. Moreover, economic data was generally underperforming, whether it be labor markets, industrial production or consumption. While a lot of this uncomfortable mix could be blamed on supply-side woes, it still put central banks in an uncomfortable position, which troubled investors.

Starting in September, central banks in Norway, New Zealand, the U.K., Canada and Australia all did or said things which unnerved bond markets. With the Fed announcing the end of its QE program next year, and the European Central Bank (ECB) expected to do so in December, markets had additional reasons to worry. If central banks tightened global liquidity conditions too quickly, it could undercut the economy and make the current slowdown in growth (mostly supply-side driven) worse, undermining risky assets such as high yield and equities while helping long-maturity risk-free bonds.

Short-maturity bond yields shot higher over the last week of October and early November. Significant increases in official rates were forecasted in many countries. For example, over the next 12 months, markets expect central banks to hike rates in New Zealand (180 bps), Norway (100 bps), Canada (120 bps), the U.K. (90 bps), Australia (80 bps), the U.S. (45 bps) and ECB (10 bps). These numbers have come down from their peaks a week ago but still look uniformly high; not impossible, just improbable. And remember that, for example, the Reserve Bank of Australia has emphasized it has no intention of raising rates until at least the second half of 2023! A long way off. It is also hard to believe that the industrial world can hike rates by this much if the Fed and ECB remain on the dovish end of the spectrum. Indeed, these predictions are higher than the respective central banks are predicting. In particular, the Fed continues to emphasize they have not achieved their labor market goals and will not hike at all until labor markets tighten further as measured by a combination of employment, unemployment rate, participation rates and inclusiveness. If the Fed and the ECB execute according to their forecasts, then it is very unlikely the other central banks will be able to pull away from the Fed/ECB/Bank of Japan peloton.

Thus, we believe the market overreacted to central bank actions and we do not believe in the stagflation narrative. Growth is likely to rebound in the fourth quarter (the eurozone has its supply-side and COVID-19 issues) and inflation is likely to stay high, if not go higher still. October purchasing managers' indexes (PMIs) showed a strong post-delta wave recovery in services with supply disruptions continuing to hold back manufacturing. Asia is doing better, and the latest U.S. employment report was quite positive, although supply issues continue to hold down the participation rate. Moreover, global household savings remain elevated and financial conditions are easy and will remain easy even if there is modest central bank tightening, whether through tapering or elimination of QE or actual rate hikes.

This relatively sanguine monetary policy outlook is not without risk. Inflationary pressures are not abating or at least not abating fast enough. Worries about second round effects and surging housing markets worry central banks. The most recent surge has come from higher energy prices (especially European natural gas prices), but the pressure is more broad-based: many other commodities (e.g., food, a particular concern for EM central banks) are also at multi-year highs, COVID-induced bottlenecks continue to cause shortages in many consumer goods supply chains, and there are widespread reports of labor shortages across developed economies. It is currently unclear just how persistent, or permanent, many of these issues are. But what is certain is that the current surge in inflation is expected to last longer than previously thought, with economists now forecasting it will only return to more normal levels towards the second half of 2022. Thus, the need for central banks to play defense, and engage in risk mitigation

strategies which imply reduced accommodation.

Going forward, we expect central banks to move slowly and deliberately. They will look through high headline inflation and avoid doing anything to suggest policy needs to be "tight" rather than just less easy. But, with all central banks thinking along the same lines (to varying degrees), it is easy for individual central banks to hike rates under cover of the central bank "peloton". As long as no one gets too far out in front, it will be easier for the global central banking community to collectively move rates higher.

Currently, markets expect a quick hiking cycle to lower-than-historic peak rates. The risk to bond valuations comes more from the length of the hiking cycle and the eventual terminal policy rate, and not as much from the pace (although that matters for the shape of the curve). But if the market starts expecting a more normal central bank cycle, then yields could rise further. Credit investors have also become more nervous recently, causing credit spreads to widen; we think this is mainly reflective of how tight spreads had become rather than any meaningful increase in default risk or deteriorating fundamentals.

Where does this leave our views on markets? In general, we remain overweight the riskier, cyclical sectors, but we have been reducing risk at the margin given valuations and increased volatility/uncertainty. On government bonds, we expect yields to drift higher at the longer end of the yield curves, but this is likely to be a long, laborious process given high global liquidity/savings and a likely slow tightening cycle. That said, low expected terminal rates and highly negative real yields make longer-maturity bonds relatively unappealing. Shorter-maturity bonds are more interesting due to much higher risk premiums now priced in. We remain overweight corporate and securitized credit, particularly lower quality investment grade bonds and selective high yield and are overweight in selective emerging markets (like Egypt and Dominican Republic), where there are, in our view, idiosyncratic reasons to be bullish.

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

FUND FACTS

Launch date	Base currency	Index
01 November 1989	U.S. dollars	Blended Benchmark

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

	OCTOBER '20 - OCTOBER '21	OCTOBER '19 - OCTOBER '20	OCTOBER '18 - OCTOBER '19	OCTOBER '17 - OCTOBER '18	OCTOBER '16 - OCTOBER '17
MS INVF Global Bond Fund - A Shares	-0.85	5.60	10.30	-3.16	3.06
Blended Benchmark	-1.24	5.63	9.54	-2.05	1.18

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 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

The **Blended Index** performance shown is calculated using the **JPM Global Traded Unhedged Index** from inception through 31 March 2004, the **FTSE WGBI Index** to 31 January 2010 and the **Bloomberg Global Aggregate Bond Index** thereafter.

The **Bloomberg Global Aggregate Index**: provides a broad-based measure of the global investment grade fixed-rate debt markets. Total Returns shown is unhedged USD.The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

The **JPM Global Traded Unhedged Index:** provides a broad-based measure of the global investment grade fixed-rate debt markets. Total Returns shown is unhedged USD.The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

The **FTSE WGBI Index:** measures the performance of fixed-rate, local currency, and investment grade sovereign bonds. The WGBI provides a broad benchmark for the global sovereign fixed income market.

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