Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Investment Funds

Emerging Markets Debt Fund

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MONTHLY COMMENTARY | SEPTEMBER 30, 2017

FOR PROFESSIONAL CLIENTS ONLY.

PERFORMANCE REVIEW

In the one month period ending 30 September 2017, the fund's I shares returned 0.27% (net of fees) while the benchmark returned -0.01%.

Overweight positions in Argentina and Brazil contributed to relative performance, as did security selection in Argentina and Russia. Conversely, an underweight position in China, Lebanon, Malaysia, Colombia and Costa Rica detracted from relative performance.

MARKET REVIEW

Emerging markets (EM) external sovereign and quasi-sovereign debt returned -0.01% in the month, bringing year-to-date performance to 8.73%, as measured by the JP Morgan EMBI Global Index. Higher-yielding, lower-rated credits outperformed lower-yielding, higher-rated credits on a relative basis in the month. Bonds from Belize, El Salvador, Venezuela, Ukraine, Ecuador, Costa Rica, Belarus and Argentina outperformed the broader market, while those from Turkey, Nigeria, Jordan, Iraq, Zambia and South Africa lagged.

EM fixed income asset returns were mixed in the month with rising U.S. Treasury yields negatively impacting dollar-denominated bond prices and a strengthening U.S. dollar weighing on EM foreign currency (FX). EM fixed income strategies continued to gain assets with investors allocating $16.2 billion across hard currency, local currency and blended strategies, bringing the year-to-date total to $91.7 billion. Energy prices rose in the month, mitigating year-to-date losses for oil and coal while hard commodity prices for gold, silver and platinum fell in the month. Soft commodities were mixed with prices for corn, wheat and soybeans rising while coffee and cotton prices fell. Overall, global macroeconomic conditions continue to be supportive for EM fixed income assets as global growth was revised upwards for 2Q, inflation faces downward pressure, and central bank policies remain supportive, amid a slow process of policy normalisation in the U.S. EM fixed income assets have broadly rallied year-to-date, but investors are still being selective on the basis of fundamentals. Valuations and positioning could have a greater impact on performance as political risks remain elevated (i.e. with issues such as North Korea and U.S. trade talks) going into the end of the year and must also contend with China's National Party Congress in October and the U.S. debt ceiling deadline in December.

PORTFOLIO ACTIVITY

During the month we added holdings in Tajikistan, Mexico and Chile, while trimming exposure in Brazil.

STRATEGY AND OUTLOOK

From a fundamental perspective, EM economies, in aggregate, have continued to improve. The EM/developed market (DM) growth differential appears to be recovering

FUND FACTS

Fund launch
April 1995

Investment team
Eric Baurmeister, Warren Mar, Sahil Tandon

Location
New York

Base currency
U.S. dollars

Benchmark
JP Morgan Emerging Markets Bond Index Global

in favour of EM as the negative growth impacts from Brazil and Russia lessen. China's growth slowdown is likely to continue in the medium-term, with better-than-expected short-term growth likely to be challenged by policy-induced tightening in financial conditions. In the U.S., the "Trump reflation trade" that markets have shunned during most of the year, is now being revisited, leading to a selloff in U.S. Treasury yields, a partial reversal of dollar weakness, and underperformance of EM risk (particularly EMFX). The recent price action can be explained by the U.S. Federal Reserve's (Fed's) determination to continue the gradual withdrawal of monetary stimulus despite subdued inflationary pressures, and a Trump administration seemingly more focused on fiscal stimulus via the recent announcement of a tax reform proposal. Though final enactment of the tax reform is not assured (and its implications on U.S. growth are also uncertain), the market is pricing in higher odds of its successful implementation, which may weigh on EM assets, at least in the short term. Volatility has remained low as investor concerns have been offset by global central bank liquidity, despite U.S. Fed rate hikes and talk of balance sheet reduction. This positive fundamental outlook could be threatened by a variety of factors including: a sharp return of volatility, monetary policy missteps, or a flare-up in geopolitical tensions. De-globalisation risks are likely to intensify in the short term as the North American Free Trade Agreement (NAFTA) renegotiation talks approach a crucial stage, but we remain constructive on the final outcome. A U.S. withdrawal from the agreement would be economically self-defeating, causing severe disruptions in the existing value chains of key U.S. industries. Moreover, the political gain from exiting NAFTA does not appear to be clear-cut, since there are segments of the President's support base that stand to lose significantly from such a decision (for example, states with strong agricultural sectors).

We remain optimistic about the prospects for EM fixed income for the remainder of 2017 as country fundamentals and the macroeconomic environment remain supportive. The various factors both pushing and pulling investors into EM fixed income remain in place: DM yields remain very low, economic data in EM appears to be recovering, Fed rate hikes are likely to remain gradual, U.S. protectionist inclinations have diminished and concerns of a sharp slowdown in China have eased. We believe that EM assets should be able to weather Fed rate hikes if driven by increasing U.S. growth and not inflation; however, assets remain vulnerable to spikes in U.S. policy uncertainty from undue Fed hawkishness, or Chinese policy tightening triggering a sharper-than-expected growth downturn. We are also cognisant of potential geopolitical risks which may flare up and trigger spikes in volatility. However, we anticipate such events will be transitory and idiosyncratic to specific countries, rather than systemic.

For further information, please contact your Morgan Stanley representative.

Collective Investment in Transferable Securities ("UCITS").

The purpose of this document is to provide a commentary on the performance and management of the Fund. Any discussion of individual stocks is included solely for that purpose and concerns the way in which the Company has sought to use that stock, in combination with others, in seeking to pursue the Fund strategy as a whole. Any comments should therefore not be taken out of context and should not be treated as advice on or a recommendation as to whether to transact in that stock.

The views and opinions are those of the Investment team as of the date of publication and are subject to change at any time and may not necessarily come to pass. The views expressed do not reflect the opinions of all Investment teams at Morgan Stanley Investment Management (MSIM) or the views of the firm as a whole, and may not be reflected in all the strategies and products that the Firm offers. This communication is not a product of Morgan Stanley's Research Department and should not be regarded as a research recommendation. The information contained herein has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations. In particular, the Shares are not for distribution in the United States or to US persons.

Applications for shares in Morgan Stanley Investment Funds should not be made without first consulting the current Prospectus, Key Investor Information Document (KIID), Annual Report and Semi-Annual Report ('Offering Documents'), or other documents available in your local jurisdiction, which are available free of charge from the Registered Office: European Bank and Business Centre, 6B route de Trèves, L-2633 Senningerberg, R.C.S. Luxemburg B 29 192. In addition, all Italian investors should refer to the 'Extended Application Form', and all Hong Kong investors should refer to the 'Additional Information for Hong Kong Investors' section, outlined within the Prospectus.

Copies of the Prospectus, Key Investor Information Document, the Articles of Incorporation and the annual and semi-annual reports, in German, and further information can be obtained free of charge from the representative in Switzerland. The representative in Switzerland is Carnegie Fund Services S.A., 11, rue du Général-Dufour, 1204 Geneva. The paying agent in Switzerland is Banque Cantonale de Genève, 17, quai de l'Ile, 1204 Geneva.

The source for all performance and index data is Morgan Stanley Investment Management Limited. Calculations are NAV to NAV. Performance is quoted net of fees and with income reinvested. The indices do not include any expenses, fees or sales charges, which would lower performance. The indexes are unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

For cash management purposes the Fund may invest in shares in the Liquidity Funds of Morgan Stanley Liquidity Funds.

This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong.

This document should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"), (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. In particular, for investment funds that are not authorized or recognized by the MAS, units in such funds are not allowed to be offered to the retail public; any written material issued to persons as aforementioned in connection with an offer is not a prospectus as defined in the SFA and, accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply, and investors should consider carefully whether the investment is suitable for them.

This document may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this document in another language, the English version shall prevail.