Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Investment Funds

Emerging Markets Debt Fund

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MONTHLY COMMENTARY | OCTOBER 31, 2017

FOR PROFESSIONAL CLIENTS ONLY.

PERFORMANCE REVIEW

In the one month period ending 31 October 2017, the fund's I shares returned 0.51% (net of fees) while the benchmark returned 0.18%.

Security selection in Argentina and Indonesia contributed to relative performance, as did overweight positions in Ukraine, Turkey, Indonesia and Ghana. Conversely, security selection in Venezuela and Mexico detracted from relative performance, as did an overweight position Mexico and an underweight position in Malaysia.

MARKET REVIEW

Emerging market (EM) external sovereign and quasi-sovereign debt returned +0.18% in the month, bringing year-to-date performance to 8.92%, as measured by the JP Morgan EMBI Global Index. High-yielders and commodity exporters outperformed during the month. Bonds from Ecuador, Ghana, Jordan, Mongolia, Angola, Egypt, Paraguay and Argentina outperformed the broader market, while those from Belize, Turkey, Mexico, South Africa, Lebanon, Belarus and Pakistan lagged.

The performance of fixed income in EM was mixed in October. Despite rising U.S. Treasury yields, the external and corporate debt indices generated positive returns, while domestic debt registered its worst monthly performance of 2017. Still, the global backdrop remains supportive: EM growth is recovering, inflation is generally low and major central banks remain accommodative despite gradual policy normalisation. EM fixed income assets have performed well year-to-date, and investors are being selective on the basis of fundamentals and valuations. Going into year-end, positioning and political risks (e.g. North Korea, North American Free Trade Agreement (NAFTA), U.S. Tax Reform) could have a greater impact on performance. In addition, the November Organization of the Petroleum Exporting Countries (OPEC) meeting and President Trump's nomination of the next U.S. Federal Reserve (Fed) Chair could stoke volatility.

Central banks were active during the month. In Argentina, the Central Bank of Argentina (Banco Central de la República Argentina (BCRA)) surprisingly hiked its policy rate by 150 basis points to 27.75%, citing higher gasoline prices and core inflation pressures. After missing this year's inflation target, the bank is focused on anchoring expectations for 2018. In Colombia, against market consensus for a hold, the Central Bank of Colombia (Banco de la República (BanRep)) cut its policy rate by 25 basis points to 5%, flagging a widening output gap and more sanguine inflation outlook as its motivation. In Mexico, the Central Bank of Mexico (Banco de México (Banxico)) announced a U.S.$4 billion foreign currency (FX) intervention to support the peso, which underperformed significantly during the month, as investors recalibrated their expectations for NAFTA negotiations and the 2018 presidential elections. The Central Bank of Russia cut rates by 25 basis points as expected, signaling its preference for a gradual continuation of the easing cycle, given the contrast between headline inflation (low) and expectations (elevated). In Brazil, the central bank's monetary policy committee (Copom) cut the selic rate by 75 basis points to 7.5%, but signaled a "moderate reduction

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 the magnitude of easing" in the future.

In China, the 19th Party Congress concluded with an emphasis on the quality rather than speed of growth, to be achieved via advanced manufacturing, rural/financial/state-owned enterprises (SOE) reforms and the Belt and Road Initiative. In Mexico, financial markets were unsettled by a contentious fourth round of NAFTA negotiations which ended in a stalemate, as well as the possibility of a leftist candidate, Andrés Manuel López Obrador, winning the 2018 presidential election, which could trigger a shift towards populist/heterodox policy. The Reserve Bank of India (RBI – the central bank) announced a plan to recapitalise public sector banks, which are expected to increase credit growth to support investment. In South Africa, Finance Minister Gigaba delivered the Medium Term Budget Policy Statement (MTBPS), which implied a significant fiscal deterioration through 2021, to be funded by increased debt issuance. The report increased the likelihood of ratings downgrades from Moody's and/or Standard & Poor's before year-end, and led to a sell-off in local rates and the rand.

PORTFOLIO ACTIVITY

During the month we added holdings in Ecuador, Argentina and Jordan, while trimming exposure in Mexico and Mongolia.

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 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, as the government emphasises the quality over the pace of growth. 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 assets). The recent price action can be explained by the 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 the U.S. Fed's rate hikes and 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 as NAFTA renegotiation talks are prolonged into 2018, 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 in 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 be systemic.

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