Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Investment Funds

Emerging Markets Debt Fund

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MONTHLY COMMENTARY | 28 FEBRUARY 2018

Performance Review

In the one month period up until 28 February 2018, the Fund's I shares returned -1.61% (net of fees)[1], while the benchmark returned -1.96%.

Underweight positions in Lebanon, Turkey, Colombia and Sri Lanka contributed to relative performance, as did security selection in Mexico. Conversely, positioning in Venezuela and overweight positions in Ukraine, Indonesia and Ecuador detracted from relative performance, as did security selection in Brazil.

Market Review

Emerging market (EM) fixed income asset performance was negative in February. Dollar-denominated corporates and local currency sovereigns outperformed dollar-denominated sovereign and quasi-sovereign credits on a relative basis as they faced the headwinds of rising U.S. Treasury yields and the prospects of U.S. Federal Reserve (Fed) rate hikes, softening commodity prices and a temporary strengthening of the U.S. dollar. Commodity prices fell for energy and precious metals (platinum, gold, silver), while prices for soft commodities such as corn, wheat and soybeans rose. A tightening of global financial conditions coincided with non-resident EM equity outflows of $5.8 billion, while EM fixed income assets experienced a modest inflow of $1.3 billion.[2] Overall, EM fixed income displayed resilience in the face of these, what we believe to be, temporary headwinds. In particular, the lack of outflows marks a shift from prior sell-off events such as the taper tantrum in 2013. This strength, especially in local markets, can be attributed to attractive real yields (versus developed markets and versus 2013), a generally positive outlook for EM currencies and improved underlying fundamentals.

EM external sovereign and quasi-sovereign debt returned -1.96% in the period, as measured by the JP Morgan EMBI Global Index. Rising U.S. Treasury yields weighed on returns for longer-dated, lower-yielding credits, while higher-yielding credits were weighed on by a pullback in commodity prices. Bonds from Belize and Trinidad & Tobago outpaced the market by posting positive performance, while those from Georgia, Ghana, Latvia, China, Lithuania and India outperformed on a relative basis. Conversely, those from Venezuela, Angola, Cote D'Ivoire, Peru, Zambia, Colombia, Lebanon and Sri Lanka underperformed.

Russia's long-term foreign currency debt rating was upgraded to investment grade (BBB-) from BB+ by S&P. The upgrade was driven by prudent fiscal policy and diminished prospects for additional material sanctions following a milder-than-expected report from the U.S. Treasury. This was the first upgrade in over a decade and could broaden the potential investor base for Russian debt as two out of the three main rating agencies now rate the debt as investment grade. Also, the Central Bank of Russia cut rates by 25 basis points to 7.50%, as expected, but issued a dovish post-meeting statement that suggests a more front-loaded easing cycle than initially expected. In South Africa, President Zuma resigned due to pressure from within his party, leaving Cyril Ramaphosa as president of the nation. Ramaphosa subsequently delivered an annual State of the Nation address as well as an annual budget speech a few days later. The budget positively surprised markets by including a long-awaited rise in VAT (value added tax). The budget also contains measures that we believe are sufficiently credible to stave off near-term fears of a Moody's downgrade in March, which would have led to South Africa's expulsion from Citi's World Government Bond Index.

Portfolio Activity

During the month, we trimmed in Ecuador, Peru, Kazakhstan, Kenya and Serbia, while adding in South Africa, Mongolia, Belarus, Egypt, Nigeria and Mexico.

1 Source: Morgan Stanley Investment Management Limited. Data as of 28 February 2018.
2 Source: Institute of International Finance. Data as of 28 February 2018.

Strategy and Outlook

The backdrop for EM continues to be supportive, as stronger global growth momentum, still subdued inflationary pressures and overall dollar weakness neutralize the potential negative effects from the recent spike in U.S. Treasury yields and stock market volatility. Global growth forecasts have been revised to the upside, primarily due to more sanguine U.S. growth expectations following the recently passed tax reform. On the EM side, Chinese authorities appear to be successful in gradually steering the economy towards more sustainable growth rates, whereas Brazil's recovery is picking up steam and India's growth is expected to accelerate to above 7%. As a result, we see the emerging market/developed market growth differential rising even further in favor of EM in 2018, potentially boosting inflows into EM. Though the downward trend in the dollar index came to a halt last month, we see the recent strength as a temporary phenomenon, as we expect a poorly-timed looser U.S. fiscal policy to worsen the current account deficit. A pickup in trade-intensive global business investment and a weak dollar should further contribute to the constructive outlook for EM, and should render the asset class less vulnerable to the ongoing gradual tightening of global monetary conditions. In fact, despite the recent spike in U.S. Treasury/bund yields, the market continues to price in a very gradual removal of monetary stimulus by the Fed and European Central Bank, consistent with the lack of obvious inflationary pressures in both economies.

Despite our constructive view of the asset class, we also note some reasons to be cautious. Valuations have tightened considerably and may offer inadequate compensation should risks materialize. Tightening labor markets, the lagged impact of rising oil prices and a looser fiscal policy in the U.S. at a time when economic slack is not obvious, may lead to upside inflationary surprises that could elicit more aggressive monetary tightening by the Fed and other developed world central banks. Geopolitical tensions are also a source of uncertainty, as well as domestic politics, primarily in key EM economies that will hold presidential elections later this year (Mexico and Brazil). However, we think these events will remain confined to specific countries, without systemic impact on the broad EM world. U.S. trade protectionist inclinations could be another source of volatility, particularly as North American Free Trade Agreement (NAFTA) negotiations reach a concluding stage, and the Trump administration considers measures to curb trade abuses by China and other nations. In regards to the former, our baseline scenario is for an eventually successful renegotiation of the NAFTA agreement sometime after the U.S. midterm elections in November, as we believe that a U.S. withdrawal will be economically self-defeating and politically costly for the Trump administration. Though we expect some trade measures against China, our base case scenario is that they will be moderate and limited to specific sectors (intellectual property, for example), as more aggressive measures may trigger an aggressive Chinese retaliation that could be damaging to the U.S. economy.

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

FUND FACTS

Launch date	Base currency	Index
01 April 1995	U.S. dollars	JP Morgan Emerging Markets Bond Index Global

12 Month Performance Periods to Latest Month End (%)

	FEBRUARY '17 - FEBRUARY '18	FEBRUARY '16 - FEBRUARY '17	FEBRUARY '15 - FEBRUARY '16	FEBRUARY '14 - FEBRUARY '15	FEBRUARY '13 - FEBRUARY '14
MS INVF Emerging Markets Debt Fund - I Shares	3.85	14.06	(2.82)	2.14	(5.85)
JP Morgan Emerging Markets Bond Index Global	3.31	12.06	1.45	4.91	(3.02)

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 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 income securities from emerging markets 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 are highly sensitive 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.
- There may be an insufficient number of buyers or sellers which may affect the funds ability to buy or sell securities.
- Investment in Fixed Income Securities via the China Interbank Bond Market may also entail additional risks, such as counterparty and liquidity risk.
- 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 28 February 2018 and subject to change daily.

INDEX INFORMATION

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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