

Morgan Stanley Investment Funds

Emerging Markets Domestic Debt Fund

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MONTHLY COMMENTARY | 31 DECEMBER 2018

Performance Review

In the one month period ending 31 December 2018, the Fund's I shares returned 0.97% (net of fees)¹, while the benchmark returned 1.31%.

Overall duration/curve positioning was beneficial in the month, while currency positioning was a detractor from relative performance. During the period, positioning in Brazil, Egypt and Poland contributed to relative returns, while positioning in Indonesia, Mexico and the Czech Republic detracted.

Market Review

Emerging market (EM) fixed income assets posted positive performance in the final month of the year, partially offsetting losses incurred throughout the year. During the month of December falling U.S. Treasury yields aided longer-duration, higher-quality bonds in the dollar-denominated sovereign and corporate market, while local bond performance drove domestic debt returns. While the market is not pricing in a recession in the near future, the outlook for global growth has continued to darken due to the risks arising from trade disputes emanating from the U.S. and the tightening of global financial conditions driven in part by rate hikes by the U.S. Federal Reserve (Fed). The optimistic trade mood generated from fitful progress on North American trade and positive signals between the U.S. and China was drowned out by the arrest of Huawei's CFO in Canada and threats by the U.S. president to close the U.S.'s southern border over internal budget disputes. Huawei is a Chinese technology company that has prompted global concerns about the use of its technology in telecom networks due to the company's purported links to the Chinese military. Over the month, energy and base metal prices continued to fall as Brent oil ended at almost \$54 per barrel and copper and aluminum prices weakened over 3%. Soft commodities returns were mixed, with corn and wheat prices rising versus losses for coffee, sugar and cotton. While base metal prices fell, prices for gold, silver and palladium rose in the period. Investors continued to withdraw investments from the EM debt asset class in December, primarily from hard currency strategies. The year ended with institutional investors adding roughly \$20 billion to the asset class, while retail investments were roughly flat.

EM domestic debt returned 1.31% in the month, as measured by the JP Morgan GBI-EM Global Diversified Index. EM currencies strengthened 0.04% versus the U.S. dollar and EM bonds returned 1.27% in local terms. Within the domestic debt universe, bonds from Mexico, Hungary, Thailand, Czech Republic and Brazil led the market, while bonds from Russia, South Africa, Indonesia and Chile lagged the most, driven by currency weakness and weaker commodity prices.

Portfolio Activity

There were no major changes in strategy during the period.

Strategy and Outlook

After a challenging year for EM fixed income, we hold a constructive outlook for 2019, driven by attractive valuations, a potentially benign global backdrop of moderate growth/subdued inflation and a Fed that is likely approaching the end of its tightening cycle. We believe these factors and growing twin deficits in the U.S. limit the scope for material U.S. dollar appreciation, which would be beneficial to EM borrowers. Our historical analysis indicates that EM fixed income tends to outperform when EM economies are closing negative output gaps and converging toward potential growth, as they are currently doing. Further support for local currency strategies should come from already adequately tight monetary policy in key EM economies and steep yield curves providing investors with excess term premium. Furthermore, overall EM foreign currency cheapness should enhance local currency returns from carry/duration, particularly if our expectation of a declining dollar and hawkish EM central banks were to materialize. Among credit, the hard currency EMBIG index screens as cheap versus both its

¹ Source: Morgan Stanley Investment Management Limited. Data as of 31 December 2018.

historical average and traditionally comparable asset classes such as U.S. high yield, while our sovereign spread model suggests that there could be attractive spread compression potential from a fundamental perspective. Similar attractive opportunities can be found in EM corporates, where absolute and relative spreads have sharply underperformed other credit markets such as U.S. and European high yield in 2018, despite generally improving fundamentals that are reflected in a similarly (low) default profile.

Despite our overall constructive tone for EM debt next year, we acknowledge several risks that could undermine our thesis. The main risk concerns a worsening of U.S.-China trade relations. Though the recent truce reached at the G-20 meeting on December 1 is a step in the right direction, a final settlement of the ongoing disputes seems elusive in our view, as U.S. grievances involve issues that are critical to China's development model and on which Chinese authorities may be reluctant to compromise. We note, though, that a tariffs/counter-tariffs regime may also generate shifts in trade flows and relocation of supply chains to other countries, which could benefit several economies in EM. Moreover, the absence of synchronized global growth or loose global monetary policy implies that opportunities in EM will demand a discriminating approach to country/asset selection, especially with trade tensions and geopolitical risks on the rise. EM-specific drivers that are worth monitoring include policy signals from incoming administrations in systemically important EM countries such as Mexico and Brazil. Regarding the former, Mexican President Andres Manuel Lopez Obrador's recent decisions to scrap the Mexico City airport and to consult the population on certain initiatives via legally questionable referenda bode poorly for policy predictability going forward. On the other hand, statements from the incoming Brazilian President Bolsonaro are more constructive, as he unveils a market-friendly economic agenda prioritizing fiscal consolidation, and particularly a swift pension reform. Finally, elections will be held in several EM economies in 2019 that, if resolved positively, could provide further impetus to reformist agendas. In particular, we highlight important electoral contests in Indonesia, Ukraine, India, South Africa and Argentina.

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 (%)

	DECEMBER '17 - DECEMBER '18	DECEMBER '16 - DECEMBER '17	DECEMBER '15 - DECEMBER '16	DECEMBER '14 - DECEMBER '15	DECEMBER '13 - DECEMBER '14
MS INVF Emerging Markets Domestic Debt Fund - I Shares	-7.47	14.61	8.00	-16.69	-6.67
JPM GBI - EM Global Diversified Index	-6.21	15.21	9.94	-14.92	-5.72

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



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 fund's 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 31 December 2018 and subject to change daily.

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 EMBI Global Bond Index:** is a custom index represented by performance of the JP Morgan EMBI Global Bond Index (which tracks the performance U.S. dollar - denominated debt instruments issued by emerging markets) for periods from the Portfolio's inception to September 30, 2007 and the JP Morgan GBI-EM Global Diversified Bond Index (which tracks local currency government bonds issued by emerging markets) for periods thereafter.

DISTRIBUTION

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 to US persons.

Ireland: Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's, Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Regulated by the Central Bank of Ireland. **United Kingdom:** Morgan Stanley Investment Management Limited is authorised and regulated

by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA, authorised and regulated by the Financial Conduct Authority. **Dubai:** Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158). **Germany:** Morgan Stanley Investment Management Limited Niederlassung Deutschland 4th Floor Junghofstrasse 18-26, 60311 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** Morgan Stanley Investment Management Limited, Milan Branch (Sede Secondaria di Milano) is a branch of Morgan Stanley Investment Management Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), and whose registered office is at 25 Cabot Square, Canary Wharf, London, E14 4QA. Morgan Stanley Investment Management Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 08829360968. **The Netherlands:** Morgan Stanley Investment Management, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of Morgan Stanley Investment Management Limited. Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Switzerland:** Morgan Stanley & Co.

International plc, London, Zurich Branch. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-115415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41 (0) 44 588 1074.

Australia: This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accepts responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act. **Hong Kong:** 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. **Singapore:** 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 material has not been reviewed by the Monetary Authority of Singapore.

IMPORTANT INFORMATION

EMEA: This marketing communication has been issued by Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's, Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Authorised and regulated by Central Bank of Ireland. ("MSIM Ireland").

This document contains information relating to the sub-fund ("Fund") of Morgan Stanley Investment Funds, a Luxembourg domiciled Société d'Investissement à Capital Variable. Morgan Stanley Investment Funds (the "Company") is registered in the Grand Duchy of Luxembourg as an undertaking for collective investment pursuant to Part 1 of the Law of 17th December 2010, as amended. The Company is an Undertaking for Collective Investment in Transferable Securities ("UCITS").

Applications for shares in the Fund 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 is 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, KIID, 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'Île, 1204 Geneva. The document has been prepared solely for informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy.

Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

The views and opinions expressed are those of the portfolio management team at the time of writing/of this presentation and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. These comments are not representative of the opinions and views of the firm as a whole. Holdings, countries and sectors/ region weightings are subject to change daily. All information provided is for informational purposes only and should not be deemed as a recommendation to buy or sell securities in the sectors and regions referenced. Information regarding expected market returns and market outlook is based on the research, analysis, and opinions of the team. These conclusions are speculative in nature, may not come to pass, and are not intended to predict the future of any specific Morgan Stanley Investment Management investment. Past performance is no guarantee of future results.

All investments involve risks, including the possible loss of principal. The material contained herein has not been based on a consideration of any individual client circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the applicable European or Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

MSIM Ireland has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. MSIM Ireland shall not be liable for, and accepts

no liability for, the use or misuse of this document by any such financial intermediary. If you are a distributor of the Morgan Stanley Investment Funds, some or all of the funds or shares in individual funds may be available for distribution. Please refer to your sub-distribution agreement for these details before forwarding fund information to your clients.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to

third parties without MSIM Ireland's express written consent.

All information contained herein is proprietary and is protected under copyright law.

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.