Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Euro Bond 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 0.40% (net of fees)[1], while the benchmark returned 0.28%.

Overall, the Fund's allocation to credit had a small positive impact this month, driven by positioning within industrials (basic industry, consumer non-cyclical and energy) as spreads were wider across the risk spectrum. High yield exposure had a neutral impact on performance in December. The allocation to government-related bonds had a positive impact on performance. Duration positioning had a small positive impact on performance, driven by the overweight to euro rates at the longer end of the curve. Positioning within European government bonds had a positive impact on performance, driven by the underweight to France.

Market Review

December was a mixed month for fixed income assets. The broadly anticipated rate hike in the U.S. had a lesser impact on the rates market than the acknowledgment by the Federal Reserve (Fed) that tighter financial conditions may slow the U.S. economy. The more dovish stance of the Fed led Treasuries 30 basis points (bps) tighter across the curve (28 bps lower on the 30-year maturity), with a positive spill-over effect on the broader dollar and emerging market blocs. The agreement between the European Union (EU) and Italy on the Italian budget helped European sovereign rates to rally, with Italian government bonds lower across the curve (37 bps, 53 bps and 47 bps lower on the 2-, 5- and 10-year maturities, respectively); peripherals were also positively impacted, with Spanish and Portuguese benchmarks 9 bps and 11 bps lower, respectively. EU core government bonds also performed well, with German bund 10-year yields down 7 bps, while France saw OAT 10-year yields 3 bps higher, as the *Gilets Jaunes* riots led President Macron to increase 2019 budget deficit targets. Ten-year U.K. gilts were 9 bps lower in the month, as perceived a safe haven amid Brexit negotiations, which don't seem to find a positive direction of travel, even after Theresa May's victory of the confidence vote early in the month. We saw continued weakness in oil prices, as West Texas Intermediate crude closed the month down 22% (down 38% in the fourth quarter) and equities touched bear market territory, with the S&P 500 Index down 9.2% in the month – led by the tech sector – and down 20.06% from intraday peak of September 21 to Christmas Eve's closing.

In credit, European investment grade (IG) spreads were 3 bps wider in December, closing the month at 152 bps and 65 bps wider for the year. Spreads were relatively quiet during the month, as secondary markets seemed to have finally repriced to their new level after the October and November widening (which brought the cash IG index, the Markit iTraxx Europe Index, 37 bps wider in the last quarter). Sterling IG credit (+3 bps) performed in line with EU IG credit, while U.S. IG spreads were 16 bps wider, suffering from turbulence in U.S. equity markets. In Europe, industrials (+4 bps) underperformed utilities (+1 bp) and financials (+1 bp), with spread widening broad based across sub-sectors. December was a quiet month on the issuance side due to seasonal slowness approaching year-end, with liquidity declining both on primary and secondary markets. December gross issuance amounted to €6 billion (€1 billion in financials and €5 billion in non-financials), down from €48.6 billion in November. Sterling gross issuance was very weak in December, with only £0.3 billion in financials, down from £2.5 billion in November.

The U.S. yield curve initially flattened for the same reasons as it did earlier in the year – expectations of the Fed steadily hiking rates with a subdued inflation backdrop and falling term premium. Towards the end of the month, however, the 2-year/10-year curve reversed much of this flattening and steepened to end the month approximately where it started. Breakeven inflation rates fell significantly across the curve in December based on expectations of slowing growth in 2019 and falling oil prices. U.S. Treasury inflation-protected securities (TIPS) valuations are approaching fair value, but we do not believe oil and equity markets have bottomed. In addition, momentum in the asset class is very negative. We expect that TIPS need to trade cheaper before generating significant investor interest.

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

The December Federal Open Market Committee (FOMC) meeting garnered significant attention from market participants. While the FOMC hiked the federal funds rate, as expected, to 2.25% to 2.50%, all eyes were on the changes to the Economic Projections versus September. There were three key changes:

1. The long-run Fed policy rate projection fell from 3.0% to 2.8% (sub 3% is the key message);

2. Core inflation as measured by the Personal Consumption Expenditure Price Index is now projected to hit the targeted 2%, down from the above target level of 2.1%; and

3. The unemployment rate is projected to remain stable at 3.5%, rising only to 3.8% by 2021, but below the FOMC's long-run forecast of 4.4%.

The FOMC is communicating through their Summary of Economic Projections that we are at full employment and inflation is at target and under control. In other words, their dual mandate has been fulfilled for the time being. The Fed believes it is engineering a soft landing, and will now pause, but market pricing, when including term premia, is indicating the possibility of another hike. This is a signal that officials are still optimistic about the U.S. economy. On the political front, President Trump shifted course on the 2019 spending bill. He reverted to his original position that he would only sign a bill that included $5 billion of funding for a border wall, starting a partial government shutdown at midnight on December 22.

In the U.K., the political environment has become increasingly complex. However, fundamentally very little has changed. Prime Minister May delayed the Withdrawal Agreement vote in the House of Commons to January due to a lack of sponsorship, and there is still no agreement on the backstop for the Irish border. While PM May survived a vote of no-confidence from rebel Conservatives triggered by widespread opposition to her Brexit deal, she only succeeded by pledging to step aside before the next general election. U.K. Brexit uncertainties and weakening economic data led U.K. markets to remain volatile in early December. The market has progressively priced out the probability of the Bank of England Monetary Policy Committee (MPC) hiking rates. The first 25 bps rate hike from the MPC is now not expected until mid-2020. Labour market data continues to be the only positive data in the U.K. Headline wage growth accelerated to 3.3% year-over-year, a level that the MPC has stated is compatible with them delivering their inflation objectives. More forward-looking data looks notably weak. In this context, U.K. yields fell modestly versus their U.S. counterparts in December. The 5-year fell 4 bps lower to 0.90% and the 10-year fell 9 bps to 1.36%.

In the eurozone, the much-anticipated European Central Bank (ECB) meeting on December 12 was uneventful. ECB President Draghi's message on the euro area macro outlook was 'continuing confidence with increasing caution'. Despite downward revisions to the growth and inflation outlook, the ECB confirmed that quantitative easing will stop at year-end. In mid-December, Rome and Brussels struck a deal over Italy's 2019 budget, ending the two-month impasse. The agreed upon budget has Italy with a 2019 budget deficit of 2.04%, versus the original budget deficit of 2.4% presented by Rome. This led Italian nominal yields to fall considerably during December. The 5-year and 10-year yields fell 53 and 47 bps, respectively.

Portfolio Activity

There were no material changes to the Fund's portfolio during the month.

Strategy and Outlook

Strategy:

The Fund is overweight to credit. In particular, it holds high-quality corporate hybrids and subordinated financials (a mixture of banks and insurance companies in the lower Tier 2 part of the capital structure of systematically important institutions).

The Fund is underweight duration.

Outlook:

U.S. growth is likely to be lower in 2019 as the fiscal impulse wears off and the lagged effect of higher rates bite, but not collapse. Recent speeches from the Fed policymakers give us further confidence that they are cognizant of the risk of over-tightening and the need to move (at some point in the near future) to a more data-dependent policy. The Fed wants to contain inflation risk; it does not want to cause a hard landing/recession. It is therefore likely that the market may also acknowledge that the peak in the U.S. Treasury 10-year yield is likely to be below 3.50% and the low likely above 2.50%. In the shorter term, despite the dip lower towards the end of December, we believe that the U.S. 10-year Treasury yield is likely to spend a majority of the time between 2.75% and 3.25% for the next several months.

A longer-term risk is a wider band for Japanese government bond yields, as the Bank of Japan (BoJ) adjusts the yield curve control policy. This could introduce more volatility and create an upward push for risk-free rates. But, for now, the BoJ does not appear to be in a rush. Ultimately, we see market uncertainty revolving around whether the end of the Fed tightening cycle will produce a soft, bumpy or hard landing and whether China's stimulus policies enacted in 2018 (and likely continuing into 2019) will stabilise its economy in 2019. Additional considerations reside with Europe and Brexit – political risks that are difficult to value.

In the eurozone, the ECB will likely continue to diverge from the Fed's monetary policy, providing support for low eurozone bond yields. Weaker economic growth in 2018, along with lower oil prices, has caused the market to price the first ECB rate hike to now only happen in early 2020. We expect the ECB, which is very focused on the path of 'underlying' inflation in the eurozone economy, will raise rates earlier than the market currently prices because of the pick-up in wage inflation which started in the second quarter of 2018. In other words, the ECB will remain committed to the view that rising wage pressure will cause inflation to return to the ECB's target level. It also sees the economic weakness in 2018 as transitory.

In terms of currencies, we expect the U.S. dollar to weaken modestly in 2019. In the year ahead, we expect the Fed policy cycle to peak at 3% and U.S. growth rates to weaken. With the peak in both growth and rates behind us, the U.S. dollar may readjust to lower levels.

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

FUND FACTS

Launch date	Base currency	Index
01 December 1998	Euro	Bloomberg Barclays Euro Aggregate A- or Better 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 Euro Bond Fund - I Shares	-0.45	0.96	4.01	0.12	10.52
Bloomberg Barclays Euro Aggregate A- or Better Index	0.64	0.18	3.50	0.31	11.10

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.**

The Blended Index performance shown is calculated using the MSCI Euro Debt Index from inception through 30 April 2007, the Barclays Euro-Aggregate Index to 30 November 2014 and the Bloomberg Barclays Euro-Aggregate A- or Better Index thereafter.

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 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.
- 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

The **Bloomberg Barclays Euro Aggregate Bond index** is a broad-based flagship benchmark that measures the investment grade, euro-denominated, fixed-rate bond market, including treasuries, government-related, corporate and securitized issues. Inclusion is based on currency denomination of a bond and not a country of risk of the issuer. The Euro Aggregate is a component of other flagship indices, such as the multi-currency Global Aggregate index and Pan-European Aggregate Index.

The **MSCI Euro Debt Index** is a broad-based benchmark for the sovereign and credit bond markets. It includes fixed rate debt denominated in the euro, or the various European Economic and Monetary Union (EMU) currencies, and rates as investment grade.

The **Bloomberg Barclays Euro Aggregate A- or Better Index** is a benchmark that measures the investment grade, euro-denominated, fixed- rate bond market, including treasuries, government-related, corporate and securitized issues. Inclusion is based on currency denomination of a bond and not country of risk of the issuer. Only bonds with a credit rating of A- or better are included.

The **Markit iTraxx Europe Index** comprises 125 equally weighted credit default swaps on investment grade European corporate entities, distributed among 4 sub-indices: Financials (Senior & Subordinated), Non-Financials and HiVol.

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

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