A Sub-Fund of Morgan Stanley Investment Funds

Euro Bond Fund

BROAD MARKETS FIXED INCOME TEAM

Investors should note that, relative to the expectations of the Autorité des Marchés Financiers, this UCITS presents disproportionate communication on the consideration of extra-financial criteria in its management.

Performance Review

In the one month period ending 31 December 2024, the Fund's Z shares returned -0.98% (net of fees)[1], while the benchmark returned -1.15%.

Both the Fund's macro decisions and positioning within spread sectors contributed positively to performance.

Euro area spreads contributed to performance, driven by the overweights to Lithuanian and Estonian spreads.

The overweight to external and quasi-government spreads added to performance as spreads tightened.

The overweight within spread sectors contributed to performance, with most of the outperformance coming from investment grade corporate and covered bonds.

There were no material detractors from relative performance in the month.

Portfolio Activity

The Fund has 6.65 years versus the index's 6.67 years of interest rate duration as of the end of December.

The Fund reduced the overweight to Spanish and Lithuanian spreads and closed the overweight to Portuguese spreads. The Fund also trimmed the underweight to French spreads.

The Fund increased the overweight to government-related debt and reduced the overweight to external debt.

The Fund also marginally increased the overweight to investment grade corporate bonds.

Strategy and Outlook

December proved to be an eventful month in the bond market, influenced heavily by a hawkish Federal Reserve (Fed) meeting and persistent global inflation trends that underwhelmed expectations. Global government bond yields experienced notable increases across both developed and emerging markets. In the U.S., the 10-year Treasury yield rose by 40 basis points (bps), contributing to a significant steepening of the yield curve with the 2s/10s spread (the difference between 2- and 10-year yields) widening by 31 bps.[2] In Europe, the trend was similar, with Germany's 10-year yield climbing 28 bps, while the U.K. yield saw an increase of 33 bps. Emerging markets also felt the impact, with Mexico's yields rising by 42 bps and Brazil experiencing a substantial jump of 175 bps. China and Thailand were two of the only countries that saw their 10-year yields decline over the month, with yields falling by 36 bps in China and 4 bps in Thailand. The U.S. dollar strengthened throughout the month, gaining 2.6% against a basket of other currencies.[3] Notably, it outperformed the New Zealand dollar by 5.4%, the Australian dollar by 5%, and the Japanese yen by 4.7%.

Regarding spread sectors, the U.S. corporate market saw a 21-basis point widening in high yield spreads and a slight increase of 2 bps in investment grade spreads.[4] Conversely, European high yield spreads tightened by 22 bps, while investment grade corporate spreads narrowed by 6 bps.[4] Meanwhile, securitized credit spreads remained mostly stable. Agency mortgage-backed spreads experienced marginal tightening.

Overall, December highlighted significant volatility and adjustments in both the bond and currency markets, setting the stage for further developments in the new year.

Bond market volatility returned in December, with yields rising worldwide. Moreover, credit spreads widened as well, albeit less aggressively than yields. All was not completely lost, as securitized credit spreads tightened modestly. At the extreme end, Brazilian yields were up more than 100 bps in December alone as the central bank hiked its policy rate 100 bps. December's poor performance weighed significantly on 2024 returns overall. For the year, the U.S. aggregate bond index returned 1.25% while the global aggregate bond index (hedged to U.S. dollars) returned 3.4%, both significantly underperforming cash and underperforming expectations.[5] High yield corporate debt bucked the trend as returns comfortably exceeded cash.

1 Source: Morgan Stanley Investment Management Limited. Data as of 31 December 2024.
2 Source for all global government bond yields: Bloomberg L.P. Data as of 31 December 2024.
3 Source for currency data: Bloomberg L.P. Data as of 31 December 2024.
4 Source: Bloomberg L.P. Data as of 31 December 2024.
5 Source: Bloomberg U.S. Aggregate Index and Bloomberg Global Aggregate Index. Data as of 31 December 2024.

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This result is highly unusual given that developed market central banks began their long-awaited easing cycles. In fact, since the Fed began to lower interest rates in September, 10-year U.S. Treasury yields have risen to just under 90 bps. Of course, what happened is that economic data once again proved unfriendly just as the Fed became more optimistic about inflation and pessimistic about growth and unemployment. Indeed, the U.S. unemployment rate peaked as the Fed began to cut interest rates. Bad luck or bad analysis/forecasting? The answer is important as it portends what may lie ahead.

Prognostications for 2025 are likely to be challenging to hold with confidence. The last five years have been replete with surprises. First was 2020, when the pandemic changed everything by the end of the first quarter; 2021 saw an inflation surge few had forecast; then "transitory" inflation turned out to be anything but, causing 2022 to introduce the most aggressive tightening cycle in decades; 2023 brought on recession worries/forecasts, which also proved to be not just off the mark but the diametric opposite to what actually happened; and 2024 delivered continued good news on the economy, with no slowdown in U.S. growth and spectacular U.S. equity returns. So, what can we expect for 2025?

The big day is 20 January, President-elect Trump's inauguration. He has promised a slew of decisions on the first day of office. While we do not know the extent of his actions, we do know his policy agenda, whether implemented on day one through executive orders or over the course of 2025 through legislative action. We have already seen Trump's social media posts regarding tariffs on China, Canada and Mexico. It is still unknown to what extent deals will be struck with these countries or with the rest of the world. So, uncertainty reigns on this front. How this plays out is likely to be important for the evolution of economies and potentially monetary policy. Fed Chairman Powell alluded to such in his December press conference where he stated that some Federal Open Market Committee members were already incorporating their views on the economic impact of potential Trump policies into their monetary policy outlooks.

What about monetary policy? The outlook for growth and inflation are key. Most developed market central banks began cutting interest rates in 2024, with the Fed and European Central Bank (ECB) each cutting rates 100 bps on the back of lower inflation. Moreover, they have signalled further rate cuts in 2025. But a major complicating factor for both the Fed and ECB is that inflation remains above target, improvements have been spotty in the last few months and increased price pressures are likely to be in the pipeline, not least coming from higher tariff threats. Last year, the market proved too dovish about rate cuts. Will 2025 be different? Market and central bank forecasts are much more in line now than they have been in recent years, so that is something. But given the likely recovery in non-U.S. global economic growth and the ongoing resilience of the U.S. economy (led by a vibrant household sector and increasingly confident corporate sector), the outlook for rate cuts is uncertain. Importantly, is monetary policy tight? The performance of equities, house prices and resiliency of growth and inflation would suggest not. Moreover, we know that there will be changes to U.S. trade/fiscal/immigration/regulatory policies in 2025. We just do not know how extensive and how much other countries will retaliate. This further muddies the water when it comes to predicting rate cuts around the world in 2025.

It is distinctly possible that current levels of developed market yields around the world are close to fair value. If the Fed and ECB do not cut rates at least 50 bps more in 2025, it is difficult for bonds to rally. With fiscal policy likely to remain loose around the world and inflation sticky (even if continuing to drift lower), the term premium on bonds could continue to rise. Indeed, one of the major contributing factors to higher bond yields in December was the rise in risk premiums on longer-maturity government bonds. However, risk premiums are still below long-term averages and are still likely to move higher — the timing and extent of which remain distinctly uncertain. It is very possible that U.S. Treasury yields remain in a broad 4%-5% range in 2025, which, if it did happen, would be a big positive after 2024's mediocre performance.

Other developed country bond markets look better positioned than the U.S. Treasury market, but that is faint praise as many issues facing the U.S. are also present in other countries. Indeed, German and Canadian government bonds have performed very well in 2024 with respect to U.S. Treasurys. We are more optimistic that these markets will likely be better supported in 2025. The U.K. gilt market remains interesting to us, as it appears to have similar growth (low) prospects as the eurozone but with yields and policy rates closer to those in the U.S. This may present an opportunity in 2025. Will 2025 finally be the year for strong bond returns (outside of high yield)?

As a starting point, longer-maturity U.S. Treasury yields are higher now than they were at the beginning of 2024. And, if yields do drift higher, the extra starting yield will offset some of that. We remain hopeful that bonds can beat cash in 2025, but this will require central banks to continue to cut interest rates. This looks likely but, and it is an important but, recent trends in growth and inflation (and Trumpian policy implementation) have increased the probability of rates NOT being cut in 2025. On the other hand, we believe bond returns are likely to be stronger in absolute terms compared to 2024, at least for investment grade. With the yield on the Bloomberg U.S. Corporate High Yield Index hovering around 7%, the potential to generate 8%-plus returns in 2025 will be challenging, although far from impossible. When all is said and done, we believe being long duration risk in portfolios still does not look overly appealing. While markets are in a better place than in 2024 with regard to expectations on monetary policy and the economy (no recession priced; no material increases in unemployment rates expected; better growth outside of the U.S. beginning; and continued Chinese economic stimulus), upside surprises to growth and inflation are still possible.

Credit markets are likely to continue to perform well. Absolute yields, solid U.S. economic data, strong corporate fundamentals, central bank policy support and expectations of more easing are supportive of the sector. Trump/Republican party policies (deregulation/tax cuts) should be also helpful. However, the longer-term impact of Republican policies is less clear. Greater opportunities and more regulatory leeway typically led to riskier behaviour and greater leverage, which is not usually positive for

creditors. With credit spreads on the tighter side (expensive by historical standards but not overvalued), it will be difficult to significantly outperform. We are more confident on absolute performance than relative to other sectors or asset classes. Combining fundamentals/technicals and valuation, a very selective strategy seems appropriate. We remain focused on avoiding companies and industries at risk (either from idiosyncratic underperformance, secular challenges or from increased management aggressiveness) while building as much yield as is reasonable into the portfolio without jeopardizing returns from credit losses or spread widening and without taking undue risks. Given current spread levels, it is challenging to be confident that spreads can tighten meaningfully further from here, although it's not impossible, as fundamentals at both the macro and sector levels remain strong. We still identify better opportunities in U.S. names and European banks in euro-denominated bonds.

At risk of sounding like a broken record, we continue to find the best opportunities in securitized credit, both in agency and non-agency securities. Amid the current noise and uncertainty in the world, we believe this sector can continue to perform well. U.S. households with prime credit ratings maintain strong balance sheets, which should continue to support consumer credit and ancillary structures, especially as housing prices remain firm and the unemployment rate stays low. Changes in U.S. tax policy should also be supportive. In the agency sector, higher coupon securities continue to be attractive compared to investment grade corporates and other agency coupon structures, and we believe they are likely to outperform U.S. Treasury securities. Selective asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) also remain attractive, though it is prudent to be highly selective when investing in commercial office-backed securities.

Emerging market (EM) bonds are likely to remain unloved during the early stages of the Trump-led Republican government. Stronger U.S. growth, combined with higher interest rates for a longer period and weaker global trade linkages, are not typically conducive to strong EM performance. Nevertheless, we believe that countries with solid economic outlooks, decent growth, falling inflation, high real yields and central banks willing and able to cut interest rates—despite policy changes in the U.S.—are likely to perform well. Country and security selection remain critical. We continue to avoid Brazilian bonds as fiscal and monetary risks remain unresolved. Indeed, the Brazilian central bank has been resolutely hawkish in hiking interest rates but to no avail so far. At some point in 2025, we believe Brazilian local bonds are likely to be more attractive. We think some of the higher-yielding countries with weaker trade linkages to the U.S., like Egypt, are likely to perform relatively better.

In currency markets, the dollar remains firm, and this is unlikely to change near term. While the dollar appears stretched compared to its historical levels, its fundamental support remains robust and most other currencies around the world look significantly more challenged. Easier fiscal policy, tighter monetary policy (relative to prior expectations), trade wars and stronger U.S. growth all bode well for the dollar. However, one caveat to this optimistic narrative could be a deterioration in the U.S. labour market. This would incentivize the Fed to become more aggressive in cutting interest rates given its dual mandate. Otherwise, the U.S. economy continues to excel in terms of growth, productivity, profit results and yield levels. It will be challenging for other countries to generate the kind of fundamental support that the U.S. dollar enjoys, especially with a Republican administration focused on implementing a higher tariff strategy. It seems likely that something needs to go wrong on the U.S. side to cause the dollar to fall. But, with tariffs imminent, this is difficult to see. We believe avoiding underweight U.S. dollar positions versus other developed market currencies makes sense. That said, we also believe more idiosyncratic positions in selective EM currencies do have merit—selectivity being the key word.

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

Fund Facts

Launch date	01 December 1998
Base currency	Euro
Benchmark	Primary- Euro Aggregate A- or Better

Calendar Year Returns (%)

Past performance is not a reliable indicator of future results.

	YTD	2024	2023	2022	2021	2020	2019	2018	2017	2016	2015
Class Z Shares	2.79	2.79	7.03	-16.55	-3.05	4.26	6.57	-0.30	0.98	4.02	0.21
Blended Benchmark	1.81	1.81	6.53	-17.50	-3.21	3.57	4.88	0.64	0.18	3.50	0.31

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 shares. The sources for all performance and index data is Morgan Stanley Investment Management ('MSIM Ltd'). **Please visit our website www.morganstanley.com/im to see the latest performance returns for the fund's other share classes.**

Share Class Z Risk and Reward Profile

- The fund may be impacted by movements in the exchange rates between the fund's currency and the currencies of the fund's investments.
- 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.
- Sustainability factors can pose risks to investments, for example: impact asset values, increased operational costs.
- 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, available at www.morganstanleyinvestmentfunds.com. All data as of 31.12.2024 and subject to change daily.

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The Blended Index performance shown is calculated using the **MSCI Euro Debt Index** from inception through 30 April 2007, the **Euro-Aggregate Index** to 31 December 2014 and the **Bloomberg Euro-Aggregate A- or Better Index** thereafter.

The **Bloomberg 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.

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A blended benchmark has been used because there has been a change in benchmark during the reporting period shown.

The **Bloomberg Barclays U.S. Aggregate Index** tracks the performance of all U.S. government agency and Treasury securities, investment-grade corporate debt securities, agency mortgage-backed securities, asset-backed securities and commercial mortgage-backed securities.

The **Bloomberg Barclays Global Aggregate Index**: provides a broad-based measure of the global investment grade fixed-rate debt markets. Total Returns shown is unhedged USD.The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

The **Bloomberg Barclays U.S. Corporate High Yield Index**: measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The Index excludes emerging market debt.

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