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Morgan Stanley Investment Funds

# European Fixed Income Opportunities Fund

GLOBAL FIXED INCOME | GLOBAL FIXED INCOME TEAM | MONTHLY COMMENTARY | 30 SEPTEMBER 2019

## Performance Review

In the one month period ending 30 September 2019, the Fund's Z shares returned -0.15% (net of fees)[1].

The overall macro decisions contributed negatively, particularly the duration positioning, given the sell-off experienced in rates which affected our core euro duration positioning the most. The long position in U.S. dollar rates also detracted as U.S. Treasury yields rose. The overweight to Australian dollar duration also detracted, albeit to a lesser extent. Currency positioning detracted slightly. The negative performance generated from the short sterling position and the long Japanese yen position was partly offset by the positive contribution from the long positions in Egyptian pound and U.S. dollar.

Performance from credit was positive. The overweight to investment grade credit was positive, particularly the exposure to financials and, to a lesser extent, industrials (consumer cyclical, energy). Elsewhere, the allocations to sovereign debt, non-agency residential mortgage-backed securities (RMBS) and high yield bonds were positive.

## Market Review

September was a mixed month for fixed income assets. Rates underperformed while credit markets closed marginally tighter. In addition, valuations had become demanding, making the market more vulnerable to a correction. Yields had fallen to levels normally associated with recessions, below what is appropriate for current economic conditions. Overall, while economic data remained weak in September (weak business spending and confidence, worsening corporate margins and falling global trade), it did not deteriorate further and was better than market participants' expectations. Against this backdrop, bond yields retraced a significant portion of their August rallies in September. U.S. 10-year Treasury yields closed 17 basis points (bps) higher at 1.66%. In Europe, core yields were hit particularly hard in reaction to disappointing PMIs: German bund and French OAT 10-year yields rose by 13 bps in the month, to close at -0.57% and -0.27%, respectively. Peripheral bonds outperformed core rates. The Italian BTP 10-year rallied, with yields falling by 18 bps to close the month at 0.82%. Spanish bonds also outperformed core rates (although rising 4 bps to 0.15%) following a rating upgrade to A from A- by S&P. The Greek 10-year bond was the strongest performer in the eurozone, with yields falling by 28 bps to 1.35% given improving fundamentals in the country. In the U.K., uncertainty around Brexit continued. Prime Minister Boris Johnson expressed disagreement with the prorogation ruling and reiterated the government's intention to see Brexit through by October 31. The Bank of England held rates at 0.75% on September 19, citing global trade tensions, soft growth and Brexit developments as increasing the outlook uncertainty. Gilt yields were broadly unchanged in September, closing 1 bp higher at 0.49%. Equity markets were slightly up September (S&P 500 Index +1.87%). The month started well for risk assets with the U.S. delaying tariffs in trade negotiations, but then fell back after the Saudi oil refinery attack. Oil (West Texas Intermediate) closed the month down at $55 (losing 1.87%). The VIX index declined by 14% to the 16 level.

September saw corporate spreads marginally tighter overall, reflecting the lack of market conviction to move in either direction. September also saw a partial reversal in the risk-free German government rally seen in August driving the negative absolute return in the month. U.S. investment grade closed 5 bps tighter in September to end the month at 115 bps over government bonds, with financials underperforming industrials. U.S. investment grade (IG) outperformed euro IG, which widened 2 bps to 111 bps in September. As opposed to U.S. credit, financials were broadly unchanged and outperformed non-financials, which closed 1 bp wider. Sterling IG also closed wider (2 bps) at 151 bps amid Brexit uncertainty. In Europe, primary issuance rose to €79.1 billion, which was a record for September, and included €52 billion of non-financial supply. Sterling IG issuance also rose to £10.3 billion in September. While sterling IG spreads are wide versus euro IG, sterling remains competitive as a funding currency relative to the U.S. dollar.

Developed market sovereign bonds sold off in September, reversing a portion of their August rally. The spread between the U.S. 10-year and 2-year Treasury note steepened by 5 bps as the market reacted positively to news of more constructive U.S.-China trade talks and Brexit developments.

[1] Source: Morgan Stanley Investment Management Limited. Data as of 30 September 2019.

While central banks remained in easing mode in September, the tone was not as dovish as hoped. The U.S. Federal Open Market Committee decided to cut the fed funds target range by 25 bps and the interest on excess reserves by an additional 5 bps to 1.80% on a divided vote, caught between uncertainty over global growth and a domestic economy that is holding up well. The outgoing European Central Bank (ECB) President Mario Draghi presented an extensive stimulus package at the ECB meeting, with a depo rate cut, open-ended quantitative easing, strengthened forward guidance, more generous targeted longer-term refinancing operations terms and reserve tiering for banks. However, markets were disappointed. Following Draghi's speech in Sintra, markets had expected an even more generous package. Additionally, the conflicts within the ECB on monetary policy views will make additional meaningful stimulus difficult once the new president, Christine Lagarde, takes the helm at the end of October. The Bank of Japan's Governor Kuroda said the bank would conduct operations to keep yields from falling too much but would not rule out negative yields from its options.

The U.S. Dollar Index was approximately flat against major world currencies month-over-month. Mid-month, the attack on the state-owned Saudi Aramco oil processing facilities at Abqaiq drove oil approximately 8% higher. The supply shock drove gains for Treasuries, but those gains were reversed amid heavy corporate bond issuance. The shock impacted currencies as well, driving the dollar stronger and the yen weaker as Japan is a large oil importer. This move reversed later in the month due to general weak economic data.

The global manufacturing slowdown continued during the month with PMI and ISM indicators falling into contractionary territory, with U.S. and German manufacturing data remaining below 50. However, services data remained relatively strong, supported by healthy labour markets.

Toward the end of the month, political and market focus turned to the events surrounding U.S. President Donald Trump's call with the president of Ukraine, which prompted a whistle-blower complaint. The House of Representatives announced that it would begin formal impeachment proceedings regarding the matter.

## Portfolio Activity

There was no material change in the positioning this month.

## Strategy and Outlook

### Strategy:

The Fund is long 3.38 years of duration.

The Fund is positioned to be long credit, particularly in the investment grade space where most of the exposure is expressed through financials. 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). It is also long industrials and utilities.

In currency markets, the Fund is underweight the euro, given the continued dovish stance from the ECB. It is also short the sterling, given the no-deal Brexit risk. The short U.S. dollar position was converted to a long position. The Fund is also long the Japanese yen, which is an offset to potential deterioration in market sentiment. In emerging markets, the portfolio is long Egyptian pound and Russian ruble.

### Outlook:

Global growth is likely to continue to be lower for the remainder of 2019. Central banks have become more accommodative, although divided, particularly in the U.S. and eurozone. We expect that to continue as uncertainty in the geopolitical and economic landscape remains prevalent. Three major risks we see to the outlook are Brexit, U.S.-China trade disputes and weakness in the manufacturing and trade sectors undermining the consumer. In this context, we expect U.S. Treasury yields to remain well below 2%.

Recent speeches from Federal Reserve (Fed) policymakers give us further confidence that the Fed is committed to being flexible regarding future interest rate policy. We believe additional 'insurance' rate cuts may be warranted over the next 12 months to help lengthen the economic cycle and avoid a recession. The Bank of Japan policy will remain easy, but it may be uncomfortable with 10-year Japanese government bond yields falling below -0.20%. The eurozone economy is showing limited to no signs of life, with limited upcoming catalysts for improvement. We expect peripheral sovereign bonds to continue to outperform eurozone core sovereigns on expectations of very easy ECB monetary policy.

In terms of currencies, we expect the U.S. dollar to weaken modestly for the remainder of this year. With the peak in both growth and rates behind us, the dollar may readjust to lower levels. Ultimately, we see market uncertainty revolving around trade policy, whether or not China's stimulus policies enacted in 2018 will continue to help stabilise the economy, and central bank action(s).

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

**FUND FACTS**

| | |
|---|---|
| **Launch date** | **Base currency** |
| 30 September 2014 | Euro |

## 12 Month Performance Periods to Latest Month End (%)

| | SEPTEMBER '18 - SEPTEMBER '19 | SEPTEMBER '17 - SEPTEMBER '18 | SEPTEMBER '16 - SEPTEMBER '17 | SEPTEMBER '15 - SEPTEMBER '16 | SEPTEMBER '14 - SEPTEMBER '15 |
|---|---|---|---|---|---|
| MS INVF European Fixed Income Opportunities Fund - Z Shares | 2.30 | -0.71 | 4.95 | 2.25 | -0.40 |

**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 Z 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.
- 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 30 September 2019 and subject to change daily.

### INDEX INFORMATION

The **Standard & Poor's 500® Index** (S&P 500®) measures the performance of the large cap segment of the U.S. equities market, covering approximately 80% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

The **Volatility Index (VIX)** is the ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options. It represents one measure of the market's expectation of stock market volatility over the next 30-day period. The VIX is quoted in percentage points and translates, roughly, to the expected movement in the S&P

500 index over the next 30-day period, which is then annualized.

**West Texas Intermediate (WTI)**, also known as Texas light sweet, is a grade of crude oil used as a benchmark in oil pricing. It is the underlying commodity of Chicago Mercantile Exchange's oil futures contracts.

The **US Dollar Index (DXY)** is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of US trade partners' currencies.

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