Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

European Property Fund

REAL ASSETS | GLOBAL LISTED REAL ASSETS TEAM | MONTHLY COMMENTARY | 31 MARCH 2019

Performance Review

In the one month period ending 31 March 2019, the Fund's I shares returned 3.10% (net of fees)[1], while the benchmark returned 4.20%.

Overweights in Norway and Finland positively affected performance, but this was offset by an overweight in Spain and underweights in Sweden, Germany and Belgium, which detracted. Cash also detracted from returns. Stock selection in Germany and Spain positively contributed to returns, but this was offset by less favourable stock selection in the U.K., the Netherlands and France.

Market Review

Brexit negotiations remain deadlocked as the Withdrawal Agreement has failed to be ratified in U.K. Parliament, forcing the U.K. and European Union (EU) to extend the March 29 Brexit deadline by up to seven months. However, the U.K. has also taken a decisive step away from a damaging "no-deal" Brexit after members of Parliament backed efforts to prevent a disorderly departure from the EU. As a result, the consensus view is that a soft Brexit or a second referendum remain the most likely outcomes.

Brexit turmoil has inflicted further damage on the U.K. economy since the start of the year as companies and households hold back spending, with the economy likely stalling in the first quarter. The Bank of England kept its policy on hold, and signalled they are in no rush to continue with a series of limited and gradual hikes.

The eurozone economy also lost momentum amid continued Brexit uncertainty, rising trade protectionism and slower global growth, and the slowdown appears to be more entrenched than initially expected. Facing weaker economic growth, the European Central Bank (ECB) reversed course after halting its quantitative easing program and announcing plans to tighten monetary policy at the end of 2018. Instead, it has opted to delay a planned interest rate rise and will give banks renewed access to cheap funding in another effort to prop up ailing growth.

Occupier demand remains strong across most European office markets at the start of 2019, as business expansion and demand for quality space continue to underpin occupier activity, despite increased political uncertainty and slower economic growth. Strong leasing activity continues to erode available space, with the aggregate European office vacancy rate falling to the lowest level since 2002. As a result, prime office rents have continued to grow in the majority of European office markets.

The London office sector remains resilient despite market uncertainty caused by Brexit. Occupiers increasingly favour quality over cost, however, and a two-tier market is starting to emerge, as take-up of new Grade A space outpaces that of the second-hand, refurbished market. As a result, rents for good quality space in desirable locations are seeing modest growth, aided by exceptional supply shortages of prime product, but rents for lower-quality office space have seen downward pressure as the proportion of second-hand supply has increased.

U.K. retail values are declining, as weakness in the retail occupational market persist, with retailers struggling to cope with volatile consumer spending, higher costs and the impact of long-term structural change driven by the internet. U.K. retail landlords are expecting further store rationalizations amongst retailers, and are likely prepared to offer soft leasing deals to ensure that occupancy levels remain as high as possible, which means that 2019 is likely going to see further downward pressure on rental levels.

While the retail environment has been exceptionally difficult in the U.K., conditions are much more benign in the retail markets on the Continent. As is the case in the U.K., there are growing uncertainties about landlords' future ability to increase rents as online sales increasingly eat retailers' margins. However, unlike in the U.K. we are not seeing significant retailer bankruptcies and

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 March 2019.

store closure programmes on the Continent. Occupancy cost ratios on the Continent also compare favourably to the U.K., making retail rental levels much more sustainable, even in the face of growing online sales.

Portfolio Activity

We have reduced our positions in both France and the Netherlands, but they remain the two biggest overweights in the portfolio, followed by Spain. In the U.K., we increased the exposure to the small-cap companies. We added to our positions in Germany, but it remains the largest underweight in the portfolio, followed by Sweden and Belgium.

Strategy and Outlook

Office leasing levels are expected to see further positive growth across Europe in 2019, but the growth rate is expected to slow compared to 2018 in response to moderating economic growth. Office development completions will increase in 2019 and 2020, but completions remain low historically, and with almost half of the space under construction already committed, the speculative component remains limited. Given the already tight vacancy and the low speculative development component, future completions are unlikely to address the supply shortages in many European markets, and the next two years are set to continue to be very competitive for occupiers. Robust occupier sentiment, a shortage of quality space and a measured supply response should support further rental growth across most European markets in 2019.

Buoyed by impressive volumes of occupier activity and continued demand for prime assets with secure income streams, investor interest for real estate investment remains strong. However, investor capital has become more discerning, focusing mostly on prime assets in structurally supported sectors that are seeing rental growth, including offices, logistics and alternatives such as student housing. In contrast, European retail investment markets have seen reduced activity, also for prime assets, resulting in increased uncertainty over retail asset pricing.

With prime yields already at record lows in most markets, and given the recent increase in bond yields off historic lows, we do not expect further yield compression across Europe in 2019. Activity in the London investment market continues to illustrate robust pricing, with foreign buyers still showing a willingness to pay prices that reflect values at or above pre-Brexit levels.

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

FUND FACTS

Launch date	Base currency	Index
01 September 1997	Euro	GPR General Quoted Europe Net Index

12 Month Performance Periods to Latest Month End (%)

	MARCH '18 - MARCH '19	MARCH '17 - MARCH '18	MARCH '16 - MARCH '17	MARCH '15 - MARCH '16	MARCH '14 - MARCH '15
MS INVF European Property Fund - I Shares	2.75	7.27	-1.87	-5.35	40.04
GPR General Quoted Europe Net Index	7.89	8.24	-0.46	-3.50	39.04

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 property company shares and the fund's simulated and/or realised return has experienced high 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 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 are additional risks associated with investing in real estate.
- 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 March 2019 and subject to change daily.

INDEX INFORMATION

The **GPR General Quoted Europe Net Index:** is a sub-index of the GPR General Index and is composed of listed real estate securities in the European real estate markets.

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