Morgan Stanley Investment Funds

Euro Strategic Bond Fund

BROAD MARKETS FIXED INCOME TEAM

Performance Review

In the one month period ending 31 August 2023, the Fund's I shares returned -0.12% (net of fees)[1], while the benchmark returned 0.30%.

The overweight duration positioning in developed market rates (U.K., New Zealand) was negative for performance as their yields rose.

Similarly, the overweight in emerging markets local rates (Mexico, in particular) detracted.

The long position in BTP Italias detracted on lower inflation expectations.

The overweight positioning in corporate credit (investment grade) was negative, with the major detractor being financials as spreads widened.

Similarly, high yield corporate bonds and convertible bonds also detracted.

The overweight allocation to emerging markets external debt was also negative on wider spreads (Cote d'Ivoire was the main detractor).

Elsewhere, the allocation to sovereign supranational debt was also negative.

There were no material positive contributors to relative performance in the month.

Portfolio Activity

The Fund has 6.63 years versus the index's 6.45 years of interest rate duration.

Within developed market rates, we reduced exposure to the U.K. given persistent price and wage pressures.

Within emerging markets local rates, we scaled back duration exposure in Mexico, Indonesia and South Africa to reduce risk.

The exposure to BTP Italias was gradually reduced.

The exposure to European supranationals was also slightly trimmed.

Within credit, we maintain a long position in investment grade bonds, predominantly through financials and a preference for Europe relative to the U.S., with an overall focus on the intermediate part of the curve versus the short end. Portfolio activity was muted in August, reflecting reduced secondary market liquidity in the summer. New issues late in the month offered opportunities to switch out of secondary positions that screened expensive.

Market Review and Outlook

Developed market rates were mixed in August with idiosyncratic factors driving each country's yields; however, yield curve steepening was a consistent theme. Central banks and economic data reinforced the idea that economies were near the end of the cycle, but factors also indicated that long-term yields may be structurally higher, pushing up the long end of the curve as term premium rose. As a result, while 2-year yield changes were mixed across developed markets, 30-year yields were broadly higher. In the U.S., the 10-year yield rose 15 basis points (bps). At the Jackson Hole meeting, Federal Reserve (Fed) Chair Powell largely reiterated the same cautious and balanced message from the July Federal Open Market Committee meeting. Eurozone yields outperformed as economic data continued to show signs of weakness. The central bank meeting calendar for August was light, with no surprises. The Reserve Bank of Australia held rates the same with a dovish bias. The Reserve Bank of New Zealand kept policy rates at 5.5%. The Bank of England and Norges Bank each raised rates by 25 bps.

Overall, the goldilocks scenario – where inflation falls without requiring a recession – still appears plausible. Central bankers can be comforted with slowing inflation data while labour markets and growth data remain resilient. Most central bankers are fully in a data-dependent mode, remaining open to a hawkish shift provided inflation proves stickier than expected. Given the uncertainty, it is difficult to concretely express an outright view on interest rates; however, with signs that central banks are nearing the end of the cycle and with catalysts to drive term premium higher (quantitative tightening, risk of Japanese selling, inflation risks), we continue to find steepeners attractive at certain parts of the yield curve. In terms of foreign exchange, the dollar again strengthened during August.

U.S. investment grade spreads outperformed euro investment grade spreads this month as August saw credit markets reverse some of the July rally, driven by several factors. Firstly, there were increasing concerns that central banks would retain base rates higher

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 August 2023.

for longer. Secondly, forward-looking economic indicators particularly in Europe (Ifo Business Climate Index in Germany, purchasing managers' indexes) and China signalled growth expectations were weakening. Finally, a weaker technical was driven by supply reopening in the last week of August (potentially creating expectations for strong supply in September) while demand remains muted due to the summer holiday month. The U.S. and global high yield markets recorded modest gains this month. The lower-rated, higher-beta segments of the high yield market continued to outperform.

Our base case remains unchanged with credit expected to trade in a range around current levels (having widened from the summer tights at the end of July), making carry an attractive return opportunity while spread duration offering capital gains is less likely to be a material contributor. We remain cautious on the high yield market. It appears the average spread in the high yield market could grind even lower, driven by temporarily supportive technical conditions.

The U.S. securitized credit market had a good month relative to corporate credit as fundamentals in the asset class, particularly in the residential mortgage market, remained strong. With relatively low historic delinquency levels remaining subdued, the asset class grinded tighter over the month. The European market marginally widened as the economic picture continued to deteriorate.

U.S. residential credit remains our preferred sector, with a strong preference for seasoned loans. However, we remain more cautious of commercial real estate, especially office, which continues to be negatively impacted in the post-pandemic world.

Emerging markets debt sold off across all segments of the asset class for the month. Brazil's central bank cut rates by a larger-than-expected 50 bps, which followed the lead of Chile and a handful of other Latin American countries over the past few months. In contrast, other emerging markets countries suffered currency weakness and high inflation during the month.

We remain cautiously optimistic about emerging markets (EM) debt. Over the longer term, many EM bond markets look attractive, but for now the pincer of stronger U.S. growth, weaker Chinese growth and a stronger U.S. dollar undermines their case.

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

Fund Facts

Launch date	01 February 1991
Base currency	Euro
Benchmark	Custom- Blended Benchmark

Calendar Year Returns (%)

Past performance is not a reliable indicator of future results.

	YTD	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
Class I Shares	2.63	-16.44	-2.40	4.98	8.62	-0.96	2.92	5.54	-0.32	11.18	2.43
Blended Benchmark	2.72	-17.17	-2.85	4.05	5.98	0.41	0.68	3.32	1.00	11.10	2.17

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

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.
- 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.
- Investment in Fixed Income Securities via the China Interbank Bond Market may also entail additional risks, such as counterparty and liquidity risk.
- 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 August 2023 and subject to change daily.

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INDEX INFORMATION

The **Blended Index** performance shown is calculated using the **JPM Euro Trade Index** from inception through 14 December 1998, then the **MSCI Euro Debt Index** from 15 December 1998 through 30 April 2007 and the **Bloomberg Euro-Aggregate Index** thereafter.

The **Bloomberg Euro Aggregate Bond 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.

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.

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