Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Global Asset Backed Securities 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 Z shares returned 0.87% (net of fees)[1], while the benchmark returned 1.81%.

Year-to-date, the Fund's Z shares returned 2.14% (net of fees), while the benchmark returned 0.99%. The Fund's allocations to European residential mortgage-backed securities (RMBS) generated negative returns again in December as spreads widened further across most European RMBS, and particularly U.K. RMBS. The Fund's allocations to U.S. non-agency RMBS, U.S. commercial mortgage-backed securities (CMBS) and U.S. asset-backed securities (ABS) all generated positive returns on an absolute basis, but still experienced spread widening and underperformed the Index during the month. The Fund's agency MBS positions performed better than the Fund's more credit-sensitive positions, but still slightly underperformed the Index as well, as our higher coupon agency MBS positioning underperformed the broader agency MBS market as interest rates declined. Our overall underweight to agency MBS also had a negative contribution during the month as agency MBS outperformed nearly all credit-sensitive securitized sectors. The Fund's average duration position ranged from 3.8 years to 3.1 years and averaged approximately 1.3 years shorter than the Index. This shorter duration positioning had a negative attribution of 46 basis points relative to the Index during the month, as U.S. interest rates decreased sharply in December.

Market Review

Widening securitized credit spreads and rallying interest rates continued in December. Securitized credit spreads have now widened for three consecutive months and finished wider for 2018 across most sectors. Fundamental securitized credit conditions remain sounds with low default rates, healthy consumer balance sheets and stable housing markets, but increasing volatility, greater concerns over the future health of the U.S. economy and widening spreads in other credit sectors are combining to put pressure on securitized credit spreads. Agency MBS performed well again in December with spreads tightening and rates rallying, and agency MBS returns for 2018 moved into positive territory for the first time all year. U.S. Treasury rates rallied again in December, as the Federal Reserve (Fed) raised rates an additional 25 basis points but also lowered its core inflation and forward rate policy projections. Ten-year Treasury yields fell 30 basis points to 2.69% and 2-year Treasury yields also declined 30 basis points to 2.49%.[2] For 2018, 10-year Treasury yields increased 28 basis points to 2.69% and 2-year Treasury yields increased 60 basis points to 2.49%, while 1-month Libor finished 94 basis points higher to 2.50%.

The Bloomberg Barclays U.S. MBS Index was up 1.81% in December but underperformed the Bloomberg Barclays U.S. Treasury Index by 34 basis points. For 2018, the agency MBS index finished up 1.01%, while the U.S. Treasury index finished up 0.86%.[2] Agency MBS nominal spreads tightened 5 basis points in December to 90 basis points above interpolated U.S. Treasuries (+21 basis points wider for 2018), while option-adjusted spreads tightened 6 basis points to 26 basis points above comparable duration Treasuries (+12 basis points wider for 2018).[3] The duration of the Bloomberg Barclays U.S. MBS Index shortened 0.57 years to 4.73 years during December; for 2018, the Index duration lengthened 0.3 years.[2] The Fed did not purchase any MBS again in December, and its MBS portfolio shrank by $16 billion during the month to $1.637 trillion.[4] The Fed's MBS holdings shrunk by $128 billion in 2018, and we expect its MBS portfolio to shrink by an additional $200 billion in 2019.

Non-agency RMBS spreads widened 5 to 15 basis points in December, despite still strong fundamental credit data. Home prices continued to rise, but the pace of increase is beginning to slow, with national home prices up 0.1% in October and up 5.5% over the past year.[5] Existing home sales increased 1.9% in November, the second straight monthly increase, but remain down 7.0% from a year ago.[6] Housing inventory fell again in November to 1.74 million existing homes for sale, or a 3.9 month supply based

1 Source: Morgan Stanley Investment Management Limited. Data as of 31 December 2018.
2 Source: Bloomberg L.P. Data as of December 31, 2018.
3 Source: JP Morgan. Data as of December 31, 2018.
4 Source: Federal Reserve Bank of New York. Data as of December 31, 2018.
5 Source: S&P CoreLogic Case-Shiller. Data as of December 31, 2018.
6 Source: National Association of Realtors. Data as of December 31, 2018.

on current sales volumes, and remains low by historical comparison.[6] The decline in interest rates in December should help improve home affordability. Home affordability had been steadily declining over the past several years as home prices have been rising faster than wage inflation, and mortgage interest rates had been rising as well. The National Association of Realtors Home Affordability Index, which compares the median income to the costs associated with owning a median home, showed U.S. homes to be 1% less affordable than the 20-year average measure of home affordability. The median monthly mortgage payment accounted for 17.0% of the U.S. median income in October 2018, up from 15.4% a year earlier.[6] Mortgage credit performance remains strong, with new defaults remaining low at a 0.64% annual rate in November 2018, essentially the lowest level in more than 10 years.[7] With unemployment at the lowest level since 1969 and the U.S. economy gaining strength, we expect mortgage credit performance to continue to improve in the near term.

CMBS spreads widened again in December, with AAA spreads roughly 5 basis points wider and BBB spreads 50 to 75 basis points wider. For the year, AAA CMBS spreads are now roughly 25 basis points wider, but BBB CMBS spreads ranged from 25 basis points wider to 50 basis points tighter, with much greater differentiation by collateral type and quality.[8] Commercial real estate prices rose 0.3% in November and are up 2.0% over the past year.[9] Fundamental conditions remain favorable in most commercial real estate markets, with high occupancy rates and improving operating incomes. We remain very cautious on CMBS collateralized by some retail properties, but we remain generally constructive on CMBS backed by residential properties, office buildings, hotels, industrial properties and distribution centers. Non-agency CMBS issuance slowed considerably in December, but 2018 total issuance was surprisingly high at approximately $80 billion.[8]

U.S. ABS spreads widened 5 to 10 basis points in December, but credit conditions remain positive.[3] Unemployment remains at the lowest level in nearly 50 years. Personal income rose 0.2% in November, and personal spending rose 0.4% during the month.[10] Consumer confidence declined again in December, as equity market declines weighed on consumers, but consumer confidence remains high from a historical perspective.[11] Overall consumer debt levels remain below historical levels on an inflation-adjusted basis primarily due to less residential housing debt. ABS new issuance also slowed in December, but was surprisingly high for all of 2018.

European MBS spreads also moved wider in December, as uncertainties over Brexit continue to weigh on the market. Fundamental housing conditions remain positive, fueled by historically low mortgage rates and moderate economic growth in the eurozone. The European Central Bank (ECB) and Bank of England (BOE) continue to offer accommodative interest rate policies, although the ECB has begun to taper its ABS purchases. The ECB's ABS holdings declined €0.2 billion in December to €27.6 billion.[12]

Portfolio Activity

We made several small changes to the Fund's positioning during the month, most notably increasing our European RMBS positions by 1%, reducing our U.S. non-agency RMBS by 1% and decreasing our U.S. ABS positions by 1%. We maintained our underweight in agency MBS, as we remain concerned about the impact from a further reduction of the Fed's MBS holdings.

Strategy and Outlook

We enter 2019 with a positive outlook on the securitized markets. With Libor and U.S. Treasury yields higher across the curve in 2018, and with securitized spreads wider on everything from agency MBS to credit-sensitive ABS, we begin 2019 with materially higher securitized investment yields and a still positive fundamental credit environment. Market volatility has increased and could still increase further, but ultimately we expect fundamental value and credit performance to dominate returns for 2019. We do not anticipate any near-term deterioration of credit performance in the form of increased delinquencies or defaults, but we believe that credit spreads could continue to widen in the near term as the market's appetite for risk appears to have weakened. From a fundamental perspective, we believe the U.S. economy remains strong with healthy consumer and real estate market conditions. We remain underweight agency MBS due to continued supply-demand concerns as the Fed has ended its MBS purchases and U.S. banks could potentially reduce their agency MBS holdings if their risk-based capital requirements are eased. Agency MBS spreads have widened materially this year as a function of rising rates, increasing volatility and reduced Fed purchases, but we believe these spreads might need to widen further to attract new buyers in the absence of the Fed. We may begin to taper our agency MBS underweight in the coming months if the sector continues to cheapen.

U.S. non-agency RMBS have cheapened meaningfully over the past three months and are beginning to offer attractive value again. After being one of our biggest overweight positions for the past several years, we had been slowly reducing our non-agency RMBS allocations in recent months as the relative value opportunity was becoming less attractive. Fundamental housing market conditions remain relatively healthy, although signs of softening home affordability are beginning to emerge. While we

3 Source: JP Morgan. Data as of December 31, 2018.
6 Source: National Association of Realtors. Data as of December 31, 2018.
7 Source: S&P Experian First Mortgage Default Index. Data as of December 31, 2018.
8 Source: Bank of America. Data as of December 31, 2018.
9 Source: Green Street Advisors. Data as of December 31, 2018.
10 Source: Bureau of Labor Statistics, Federal Reserve Board of St. Louis. Data as of December 31, 2018.
11 Source: The Conference Board. Data as of December 31, 2018.
12 Source: European Central Bank. Data as of December 31, 2018.

do not anticipate meaningful spread tightening going forward, we believe the current non-agency RMBS yields offer attractive carry and should still maintain a very stable credit profile.

Although CMBS spreads have widened meaningfully over the past three months, we believe spreads could still widen further and we remain cautious. CMBS spreads have historically had the highest correlations to corporate credit spreads and therefore could widen further in sympathy with spread widening elsewhere. AAA CMBS spreads remain compelling versus other AAA sectors, while lower-rated CMBS value opportunities vary significantly by individual security. In terms of specific CMBS subsectors, we still like residential-related sectors like single-family rental and multi-family housing. We also like large single-asset deals and selective seasoned conduit deals. We remain cautious on retail shopping centers, which should continue to struggle due to store closings and changes in how consumers shop.

In U.S. ABS, we continue to have a positive outlook on consumer credit sectors. Consumer balance sheets are improving due to low unemployment, increasing wages and higher savings rates, and consumer confidence remains near the highest levels in 20 years. Total consumer debt remains at reasonable levels as interest rates remain historically low, and credit card utilization rates are near the lowest levels in nearly 20 years. Additionally, ABS securitizations in the post-financial crisis era are generally being structured with very robust levels of credit protection, designed to withstand very high default levels. Security selection remains critical, but we believe consumer credit ABS can offer attractive relative value opportunities.

In European RMBS, we are becoming a little more cautious as political uncertainties increase. We still believe the fundamental credit outlook is positive and that the ECB and BOE will continue to offer accommodative interest rate environments that are beneficial to real estate and consumer credit performance, but we think that European RMBS, CMBS and ABS spreads could widen in the short term as uncertainty increases. Additionally, as the ECB ends its asset purchase program in December, pricing volatility could increase further with weakening demand. We will continue to look to opportunistically add to our European securitized positions, but we are generally focusing on higher credit quality opportunities.

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

FUND FACTS

Launch date	Base currency	Index
03 December 2012	U.S. dollars	Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) 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 Global Asset Backed Securities Fund - Z Shares	2.14	7.37	4.71	1.77	7.89
Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index	0.99	2.47	1.67	1.51	6.08

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.
- 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 31 December 2018 and subject to change daily.

INDEX INFORMATION

The **Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index:** tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage. 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. Treasury Index** includes public obligations of the U.S. Treasury.

The **National Association of Realtors Home Affordability Index** compares the median income to the cost of the median home.

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