

## Morgan Stanley Investment Funds

## Global Asset Backed Securities Fund

## MORTGAGE &amp; SECURITIZED TEAM

## Performance Review

In the three month period ending 31 March 2024, the Fund's Z shares returned 0.44% (net of fees)<sup>1</sup>, while the benchmark returned -1.04%.

The Fund (Z shares net of fees) outperformed the Bloomberg U.S. Mortgage-Backed Securities (MBS) Index (the "Index") by 148 basis points in the quarter.<sup>2</sup>

The Fund had no negative returns on an absolute basis for the quarter. The portfolio's outperformance was primarily due to its non-agency residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS) exposures given their strong cash flow carry, tightening spreads in these sectors and the shorter duration profile of these securities that makes them less negatively impacted by the rise in interest rates. The second major source of outperformance was the portfolio's underweight to agency MBS — specifically to lower-coupon, fixed-rate passthroughs — as agency spreads were unchanged and interest rates sold off. Even the Fund's allocation to agency MBS outperformed the Index as our overweight to higher-coupon MBS outperformed lower-coupon MBS due to the longer duration of lower-coupon MBS, which were more negatively impacted by the rise in rates.

Given that securitized credit spreads did tighten during the quarter, the fact that most European non-agency RMBS, global CMBS and global ABS assets are floating-rate or short-duration structures meant that they were least negatively impacted by the rise in rates and therefore were the largest contributors to performance on a relative basis.

The Fund's relative duration positioning helped relative performance slightly as the Fund's duration remained shorter than that of the Index during the quarter.

There were no material detractors on a relative basis in the quarter.

## Market Review

U.S. interest rates rose and the yield curve bear flattened during the first quarter as inflation remained high and strong economic data led the Federal Reserve (Fed) to signal that it will likely wait longer to cut interest rates, and market expectations for rate cuts fell from 150 basis points to 75 basis points for 2024. The Fed kept rates unchanged at 5.25% during the quarter and indicated cuts in the remainder of 2024 would be largely data dependent.<sup>3</sup> The Fed also continued letting its MBS holdings run off during the quarter, declining \$43 billion to \$2.380 trillion by quarter-end.<sup>3</sup> Two-year U.S. Treasury rates rose 37 basis points to 4.62% during the first quarter, and the 10-year U.S. Treasury rate rose 32 basis points to 4.20%.<sup>4</sup> U.S. commercial banks' agency MBS holdings increased during the first quarter by approximately \$22 billion to \$2.540 trillion, but bank holdings are still down \$460 billion from early 2022.<sup>4</sup> We expect both the Fed's and U.S. banks' MBS holdings to decline through the remainder of 2024. Declining savings rates have reduced bank deposits, and higher short-term rates have increased funding costs for banks and reduced net interest margins on MBS. The 30-year mortgage rate rose 18 basis points during the quarter from 6.61% to 6.79%.<sup>4</sup> MBS current coupon nominal spreads were unchanged during the quarter at 139 basis points above interpolated U.S. Treasuries. The Index returned -1.04% during the quarter, underperforming U.S. Treasuries by 13 basis points on a duration-adjusted basis.<sup>4</sup> Agency MBS underperformed Treasuries by 76 basis points for all of 2023 on a duration-adjusted basis. The duration of the Index lengthened by 0.1 years during the first quarter to 5.7 years, and the majority of the outstanding U.S. mortgage market remains "out-of-the-money" to refinance with new origination mortgage rates still at historically high levels.<sup>4</sup>

Despite spread tightening in March, agency MBS still look attractive, both from a historical perspective and relative to other asset classes. Agency MBS supply-demand dynamics have improved as the Fed continues to let its agency MBS holdings run off, but U.S. banks and foreign entities have increased their holdings recently. New MBS supply remains low as mortgage origination has been very slow due to higher mortgage rates, but MBS demand also is also expected to be weak. We expect U.S. home prices to remain relatively stable, as the difficult affordability is counterbalanced by the lack of housing supply. We expect mortgage rates to decline slightly, but not sufficiently enough to meaningfully impact affordability.

Securitized credit spreads tightened in the first quarter of 2024, but yields still remain very attractive, both from a relative value and historical perspective. Fundamental credit conditions have deteriorated with high inflation (although real wages have now turned positive) and higher debt costs eroding consumer balance sheets, but we still believe that high quality RMBS, CMBS and ABS remain well protected from a structural perspective even under more stressful conditions.

<sup>1</sup> Source: Morgan Stanley Investment Management Limited. Data as of 31 March 2024.

<sup>2</sup> One basis point = 0.01%

<sup>3</sup> Source: Federal Reserve

<sup>4</sup> Source: Bloomberg L.P. Data as of 31 March 2024.

## Portfolio Activity

We increased our agency MBS exposure by 4% to 40% during the first quarter as spreads widened during the first two months of the year, which presented an attractive entry point. Spreads have now tightened back to the level where they began the year, and we have moved from slightly positive back to a neutral stance on the asset class.

Over the period, our U.S. RMBS holdings fell 1% to 16% as we continue to try to replace runoff, and our non-U.S. non-agency exposure fell 2% to 17% as we continue to look for opportunities to reduce our European securities in favor of comparable U.S. securities. Our U.S. CMBS held at 7%, and our European CMBS holdings fell 1% to 6%. Our U.S. ABS exposures rose 2% to 10%, and our non-U.S. ABS holdings fell 1% to 4%.

## Strategy and Outlook

After several months of spread tightening across securitized products, we expect spreads to stabilize at current levels in the second quarter as securitized credit spreads are approaching agency MBS spread levels given the differentiated performance over the past several months. Overall demand levels remain strong, but we believe it will be challenging to push spreads much tighter from current levels. Securitized credit sectors have been among the best performing sectors in 2024, but we believe performance should normalize in the coming months. We also believe that rates will likely remain range-bound for much of 2024, and that returns will result primarily from cash flow carry in the coming months. We still believe that current interest rate levels remain stressful for many borrowers and will continue to erode household balance sheets, causing stress for some consumer ABS, particularly involving lower income borrowers. Commercial real estate also remains challenged by current financing rates, and some sectors may see declines in operating revenue in 2024. Residential mortgage credit opportunities remain our favorite sector currently, and it is the one sector where we remain comfortable investing lower down the credit spectrum, as we remain more cautious regarding lower-rated ABS and CMBS.

We continue to have a neutral view on agency MBS valuations, which are more expensive than 2023 levels, but remain cheap from a longer-term historical perspective. Despite the tightening of MBS spreads in March, they still remain attractive versus investment grade corporate spreads and versus historical agency MBS spreads. But we believe that further agency MBS spread tightening is less likely in the near term.

We remain most constructive on RMBS and residential-related investments. Most homeowners have locked in 30-year fixed-rate mortgages at substantially lower mortgage rates and have not faced payment shocks from higher rates. Additionally, the substantial home price appreciation over the past few years has meaningfully increased homeowner equity – in fact, homeowner equity is at the highest level in more than 40 years.<sup>4</sup> Lastly, residential mortgage lending standards have remained very conservative in the post-financial crisis era, and mortgage credit performance continues to be pristine with very minimal delinquencies and defaults.

We remain much more cautious on commercial real estate exposure, especially in the office sector. Higher financing costs have stressed all commercial real estate sectors, but sectors such as hotels, multi-family housing and retail shopping centers have seen healthy revenue growth to help offset the higher financing costs. The office sector has felt the brunt of both declining revenue and higher financing costs.

We also remain cautious on consumer ABS, as inflation, higher rates and declining government stimulus have begun to strain consumer balance sheets, especially for lower-income borrowers. The savings surplus built up during the pandemic has now been depleted, and we expect more consumer stress for the remainder of 2024. We are more constructive on business-related ABS, such as aircraft leases, mortgage-servicing rights and small business loans.

We believe that central banks are now at the end of their hiking cycles, and that rates have seen their peak levels and will likely decline through the remainder of 2024. Much of the projected rate decline has now been priced into the market with the rally in rates during the fourth quarter, but we still expect the forward path for rates will likely be lower from current levels.

We continue to prefer U.S. securitized opportunities over U.K. and European securitized markets. U.S. spreads are currently wider than comparable credit-profile European/U.K. opportunities, yet we believe the U.S. credit landscape is more favorable. European inflation has been slower to recede, and economic growth looks to be weaker in Europe. Geopolitical risks also remain higher in Europe.

Our base forecast is for a mild recession, which we do not believe would have a material impact on our securities' performance, but we also believe our securities could handle a severe recession given that they were designed with the Global Financial Crisis as a stress test. We remain watchful of ongoing geopolitical risks as well as broader economic risks across the globe. Despite these risks, we remain excited about the Fund's return potential for the remainder of 2024.

Overall, we believe the securitized market offers a unique opportunity to achieve competitive returns with solid credit fundamentals. Although volatility has increased and credit conditions are weaker, we remain constructive on securitized credit conditions overall — specifically in the U.S. — with the U.S. economy remaining strong and housing and consumer credit conditions continuing to be relatively healthy. As a result of these views, we have a meaningful credit overweight in the Fund, but we have increased our U.S. agency MBS position to its highest level in several years (40%) given our concerns of deteriorating economic conditions.

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

<sup>4</sup> Source: Bloomberg L.P. Data as of 31 March 2024.

## Fund Facts

Launch date	03 December 2012
Base currency	U.S. dollars
Benchmark	Bloomberg U.S. Mortgage Backed Securities (MBS) Index

## Calendar Year Returns (%)

Past performance is not a reliable indicator of future results.

	YTD	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014
Class Z Shares	0.44	8.18	-6.62	1.91	2.62	6.91	2.14	7.37	4.71	1.77	7.89
Bloomberg U.S. Mortgage Backed Securities (MBS) Index	-1.04	5.05	-11.81	-1.04	3.87	6.35	0.99	2.47	1.67	1.51	6.08

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](http://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.
- 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 March 2024 and subject to change daily.

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## INDEX INFORMATION

The **Bloomberg 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.

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