Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Global Bond 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 I shares returned 1.60% (net of fees)[1], while the benchmark returned 2.02%.

For the month, macro and spread decisions detracted from relative performance. Positive returns in developed and emerging markets (EM) rates contributed to relative returns. Conversely, spread product exposure (investment grade and high yield corporates, securitized, convertibles and EM dollar-denominated sovereign debt) detracted from performance.

Market Review

It was an exciting end to the year with most markets moving in a diametrically opposite direction to the consensus views earlier in the year. The December dramatic drop in 10-year U.S. Treasury yields and pricing out of all U.S. rate hikes in 2019 was driven in large part by the poor performance of risky assets: high yield and leveraged loans, the previous darling of the bond market, and equities, which saw their largest monthly drop in many years. Of course, this begs the question as to why risky assets did so badly (after all U.S. corporate earnings have been growing at a 20% plus rate), assuming that they were the dog wagging the tail of government bonds, which we think they were, well at least mostly.

These asset returns did not occur in a vacuum. Indeed, it was not one specific event or data release which was THE cause. It was a plethora of problems. Disappointing macro data across the advanced economies, ongoing political troubles (U.S.-China trade, government shutdowns), poor sentiment, market mispositioning and, of course, that old bugaboo, poor liquidity enhanced by end of year balance sheet constraints all contributed. Indeed, it is a struggle to find good news anywhere, which of course may mean it cannot get worse! We will have to see. We do know that despite the Fed raising rates eight times in the past two years, the U.S. 10-year Treasury yield has only moved up 24 basis points (bps) (post dramatic fourth quarter rally). A flattening of the yield curve of historic proportions certainly belies confidence that the U.S. economy can sustain growth much above levels prevalent post the global financial crisis.

To be fair, it actually was not all gloom and doom in December. Emerging market local government bonds had a fine month. In fact, it was a great month for some countries. Brazil 10-year yields fell 40 bps; Mexico's 53 bp! Other countries like Poland also performed well. Even Italy, faced with all sorts of problems, managed to see 10-year bonds rally 47 bps. Why? If it was such a risk-off month how did these countries perform so well? Valuations were very important, as was sentiment and news, not surprisingly. First, these were some of the worst performing markets earlier in the year and valuations had moved to relatively extreme levels. Second, sentiment was already bad; investors were not overly bullish despite low valuations. And, third, news flow either improved or stopped getting worse. Indeed, slowing U.S. growth expectations and reduced concerns about Fed tightening provided a much improved global backdrop to emerging markets.

Despite these rather large changes in asset prices, analyst forecasts, including our own, for 2019 have not changed nearly as dramatically. Yes, growth should moderate in 2019. But will it collapse? No, we do not think so. And, for the U.S. in particular, this is a good thing. If U.S. growth continued at the third quarter pace, there is no doubt in our minds that this would lead to higher inflation, more and possibly more-aggressive Fed rate hikes, and a higher probability of recession in 2020 and beyond. So the silver lining of the market's reappraisal of U.S. and global growth and inflation dynamics is that there is substantially less pressure for central banks to either normalize policy (eurozone, Japan, China) or continue to raise rates (U.S.). The risk of a more dramatic economic slowdown from a too-quick pace of tightening remains remote, in our opinion. We think that moderate growth, stable inflation and a patient Fed is an excellent recipe for engineering a soft landing for the U.S. and global economy and good performance of risky assets. The notable resilience of emerging markets in the second half of the year (dramatically so in December) is further supportive of the global economy and of the emerging market asset class.

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 December 2018.

Portfolio Activity

During the month we added to active positions in investment grade corporate debt, while trimming in securitized and Organisation for Economic Co-operation and Development government debt (New Zealand, Spain).

Strategy and Outlook

Investors hoping for a 'Santa Claus rally' in December were disappointed, with developed market equities experiencing their worst month since September 2011, while investment grade credit spreads sold off to their widest levels since the first half of 2016. On the face of it, one might have thought value-minded investors would be encouraged by the sell-off and the opportunity to buy equities at lower valuation multiples and be paid more to take on corporate default risk, but the situation is more complex than that. Economic data, especially in developed economies, generally surprised to the downside in the fourth quarter of 2018, and while company earnings generally held up well through the year, expectations for 2019 have been revised steadily lower. In addition, many of the main macro risks – trade tensions between the U.S. and China, populist politics in Europe, concerns about the slowing Chinese economy – remain unresolved.

However, the other significant development over the last month is the policy response to the weakening growth data and financial markets performance. The trend toward monetary policy normalization, which was firmly on track in the first half of the year, appears to be stuttering to a halt, and in some cases reversing. Inflation everywhere remains subdued, so central banks can take their time with normalizing policy, reducing the risks of a policy accident from tightening too much, too soon.

The Federal Reserve delivered more rate hikes in 2018 than the market had initially expected – four rather than three – but now finds itself in the situation where policy rates are approaching neutral, the risks to tightening much further seem greater and the need to do so is not particularly pressing. Inflationary pressures did recover through 2018, but U.S. core inflation measures have at most returned to the target level, rather than overshooting. U.S. job creation surged far more than expected in December, but the unemployment rate rose at the same time, as discouraged workers rejoined the workforce, suggesting there is still slack in the U.S. labor market which will moderate inflationary pressures.

In the eurozone, the European Central Bank (ECB) did end its quantitative easing program, but the path and pace of raising interest rates is expected to be an extraordinarily slow one. While the ECB is sticking with its view that the weakness in the eurozone economy is transitory and that tighter and more rigid labor markets will lead to rising underlying inflationary pressures, there is very little evidence of this translating into higher consumer prices, with the core consumer price index (CPI) unchanged at 1% year-over-year in December. As in the past, the ECB may have to push out the timing of its policy normalization.

Possibly the most significant change in monetary policy came from the People's Bank of China, as the reserve requirement ratio was cut to support the slowing Chinese economy. Interestingly, though, while emerging markets were a major source of market volatility in the first half of 2018, they managed to outperform developed markets in the second half of 2018. This improved resilience makes sense to us given most emerging economies are in better shape than many investors feared, those with imbalances took corrective actions to address them and, with valuations undemanding, there are attractive investment opportunities. A slower pace of Fed rate hikes, which may lead to a weaker U.S. dollar, could add further support to the asset class.

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

FUND FACTS

Launch date	Base currency	Index
01 November 1989	U.S. dollars	Bloomberg Barclays Global Aggregate 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 Bond Fund - I Shares	-2.63	9.57	2.37	-4.52	2.05
Bloomberg Barclays Global Aggregate Index	-1.20	7.39	2.09	-3.15	0.59

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.**

The Blended Index performance shown is calculated using the JPM Global Traded Unhedged Index from inception through 31 March 2004, the FTSE WGBI Index to 31 January 2010 and the Bloomberg Barclays Global Aggregate Bond Index thereafter.

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 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 31 December 2018 and subject to change daily.

INDEX INFORMATION

The **Bloomberg Barclays Global Aggregate Index**: provides a broad-based measure of the global investment grade fixed-rate debt markets. Total Returns shown is unhedged USD.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 **JPM Global Traded Unhedged Index:** provides a broad-based measure of the global investment grade fixed-rate debt markets. Total Returns shown is unhedged USD.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 **FTSE WGBI Index:** measures the performance of fixed-rate, local currency, and investment grade sovereign bonds. The WGBI provides a broad benchmark for the global sovereign fixed income market.

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