Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Global Credit Fund

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MONTHLY COMMENTARY | 31 JANUARY 2019

Performance Review

In the one month period ending 31 January 2019, the Fund's Z shares returned 3.00% (net of fees)[1], while the benchmark returned 2.29%.

Investment grade (IG) credit had the largest positive impact on performance, as a result of the broad-based spread tightening across global credit markets. Our overweight positioning to financials had the largest impact on performance; utilities and industrials also had a positive impact. High yield corporates and convertibles also positively contributed, the latter in particular positively benefitting from the strong performance of global equity markets in January. Our credit default swap positioning had a small negative contribution given the spread tightening we saw in January. Our U.S. dollar duration underweight also detracted from performance, as U.S. Treasuries fell across the curve in January.

Market Review

January was a positive month for fixed income assets. Both rates and credit markets re-gained confidence, as the fear of an imminent economic downturn, which affected fourth quarter 2018 performance, began to fade away and investors realized end-of-2018 valuations were attractive across the risk spectrum. The longest shutdown in the history of the U.S. government was offset by robust economic data prints, and the Federal Reserve's (Fed) dovish statements at the end of the month provided a further boost to risk assets. U.S. Treasuries ended the month 5 basis points (bps) and 7 bps lower on the 5- and 10-year maturities, respectively. The eurozone economy showed signs of broad weakness, as what previously looked like different idiosyncratic stories are now adding up to a more systemic risk. However, the European Central Bank (ECB) was also supportive of risk assets, acknowledging the growth slowdown and opening the door to a potential new targeted longer-term refinancing operations (TLTRO) in the spring. European Union (EU) core government bonds performed well in January, with German bund and French OAT 10-year yields 9 bps and 16 bps lower, respectively. The EU periphery saw Spanish and Portuguese 10-year benchmarks 22 bps and 10 bps lower, respectively, while Greek government bonds had the strongest rally, closing the month 52 bps lower. Italian BTPs spreads were lower across the curve (20, 28 and 15 bps lower on the 2-, 5- and 10-year maturities, respectively) despite a weak economy which posted a -0.2% quarter-over-quarter gross domestic product (GDP) growth on the last day of the month, meaning the economy is in technical recession. In the U.K., Parliament rejected Prime Minister May's Brexit proposed deal; however, odds of a soft Brexit have increased, which raised appetite for U.K. assets and led U.K. 10-year yields 6 bps lower. Equity and commodity markets also had a positive performance, as the S&P 500 Index closed the month 7.9% up and West Texas Intermediate crude 18.5% up, both recovering most of December's negative performance.

The beginning of the month saw a degree of weakness in spread products, with the secondary curves which repriced to primary issuance as new issues came at a significant premium. As we progressed through the month and the market moved to a risk-on sentiment, spreads began to tighten and then received a strong boost from Fed and ECB dovish statements. U.S. IG credit was the best performer, closing the month 22 bps tighter at 121 bps. Spread tightening was broad-based across sectors, with financials leading the way (28 bps tighter) for industrials (24 bps tighter) and utilities (17 bps tighter). European IG spreads rallied to a lesser extent and closed the month 11 bps tighter at 140 bps. In Europe, financials were the best performers (13 bps tighter) with notable outperformance from banking lower Tier 2 (17 bps lower) and subordinated insurance (47 bps tighter). Sterling IG credit was 12 bps tighter. Globally, the BBB rating bucket outperformed higher quality credit. Gross issuance was strong in Europe, totalling €58.1 billion (up €5.9 billion year-over-year) led by non-financial supply (which rose to €31.9 billion from €22.1 billion last year). Sterling gross issuance was flat over last year at £5 billion, coming primarily from financials (£3.35 billion) and driven by the relatively low cost of sterling funding which spurred cross-border deals. U.S. dollar gross issuance amounted at $148 billion, down from $155.6 billion last year.

The U.S. government reopened following the longest partial government shutdown in U.S. history, which lasted 35 days. President Trump signed a bill that allows the government to operate until February 15, while the government continues its

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

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negotiations on securing the U.S. southern border. While the bill provides relief to federal employees for approximately three weeks, significant progress must be made to ameliorate the points of contention between Republicans and Democrats. U.S. Treasury yields dropped across the curve, albeit by less than they dropped in December.

The month of January proved to be a productive month for U.S.-China trade discussions. While President Trump asserted that he would like to keep tariffs in place, the trade relationship between the two countries appears to be more amicable. Chinese President Xi Jinping agreed to purchase more soybeans from American producers, as well as make significant changes to Chinese economic policies. Progress was also made around agriculture and energy policies.

Chairman Powell's speech on January 4, the minutes from the December Federal Open Market Committee (FOMC) meeting and the January FOMC meeting itself all indicated that the Fed will watch and see how the economy evolves amid an uncertain economic outlook and muted inflationary pressures. While the Fed maintained its view that the economy is still strong, proven by continued strong economic data, a number of downside risks were cited by FOMC participants. Examples include concerns around a slowdown in global economic growth, a more rapid waning of fiscal stimulus, trade policy developments, a further tightening of financial conditions and greater-than-expected negative impacts from monetary policy tightening.

In the U.K., Prime Minister May's Brexit proposal was rejected by the House of Commons in a vote of 432 to 202, with just 10 weeks to go until the U.K. is scheduled to leave the EU. Subsequently, May narrowly survived a vote of no confidence on January 16. Now, May must go back to Brussels to discuss changes to the Northern Ireland backstop and present a 'Plan B'. However, the EU reiterated that the Withdrawal Agreement cannot be renegotiated. Brexit risks aside, economic data released in January generally surpassed expectations. Wage growth remained strong, as average U.K. wages grew to a decade high of 3.4%. The jobless rate fell to 4.0%, which is its lowest level since 1975. However, inflation data came in at its lowest levels in two years, driven by lower oil prices. The 2.1% reading was in line with expectations and continues to be close to the Bank of England's 2% target. The first 25 bps rate hike from the Monetary Policy Committee is 80% priced in for May 2020. Over the month, the 5-year gilt yield fell 3 bps lower to 0.87% and the 10-year fell 6 bps to 1.21%.

As expected, the ECB kept rates on hold at its January meeting. ECB President Mario Draghi reaffirmed that he expects rate hikes to continue to be kept on hold until at least through this summer, and longer if necessary. He also stated that risks surrounding euro area growth have 'moved to the downside' amid geopolitical uncertainty and financial market volatility, particularly as Brexit quickly approaches. Draghi expects incoming economic data to be weak in the coming months. This comes after weak growth data in Germany, France and Italy sparked recession concerns. Germany grew at 1.5% in 2018, which is its lowest reading in five years. Following Draghi's comments, the euro traded 0.5% lower against the dollar. The International Monetary Fund cut its growth forecasts for the region for this year and next, citing weakness in Germany and Italy as risks to the economic wellbeing of the region. Ten-year yields across Germany, France, Italy, Greece and Spain dropped over the month, with Greece and Spain seeing largest declines of 22 and 50 bps, respectively.

Portfolio Activity

We decreased our active credit exposure during the month, bringing the overall active spread duration of the portfolio down by 0.22 years. We achieved this mainly by reducing our exposure to subordinated financials in Europe.

Strategy and Outlook

Strategy:

In the portfolio, we remain biased toward financials over non-financials. Financials continue to present strong fundamentals and attractive valuations relative to non-financial credits. While we generally remain underweight non-financials, sector and name dispersion has been rising, and we continue to take opportunities to selectively add certain exposures back to the portfolio. We remain underweight industrials on concerns over increased merger and acquisition activity, technological disruption and increasing idiosyncratic news, and we thematically prefer regulated business models over unregulated (i.e. utilities) to hedge these risks. Portfolios remain tilted toward U.S. dollar credit. We continue to increase exposure to emerging market corporates as valuations look favourable relative to default expectations, while we remain selective in off-benchmark holdings of high yield and convertible bonds.

Outlook:

U.S. growth is likely to moderate this year, yet remain above potential GDP. Fed policymakers stated that they will be patient and will likely keep rates on hold for at least the next two meetings. The remainder of the year will likely depend on outcomes of several matters such as U.S.-China trade negotiations, the debt ceiling and further government shutdowns after February 15 passes. The market may also acknowledge that the peak in the U.S. Treasury 10-year yield is likely to be below 3.50% and the low likely above 2.50%. In the shorter term, we believe that the U.S. 10-Year Treasury yield is likely to spend a majority of the time between 2.75% and 3.25% for the next several months.

We now see it is less likely that the Bank of Japan moves aggressively away from yield curve control in the near term as the central bank sees an increasing downside to inflation. Ultimately, we see market uncertainty revolving around whether or not the end of the Fed tightening cycle will produce a soft, bumpy or hard landing and whether or not China's stimulus policies enacted in 2018 (and likely continuing throughout this year) will stabilize its economy in 2019. Additional considerations reside with Europe and Brexit – political risks that are difficult to value.

In the eurozone, we see signs that the ECB is likely to push the tightening cycle further out as the bank has acknowledged tightening financial conditions and is committed to keeping interest rates low.

In terms of currencies, we expect the U.S. dollar to weaken this year and expect the Fed policy cycle to peak at 2.75%. With the peak in both growth and rates behind us, the U.S. dollar may readjust to lower levels.

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

FUND FACTS

Launch date	Base currency	Index
14 November 2012	U.S. dollars	Bloomberg Barclays Global Aggregate Corporate Index

12 Month Performance Periods to Latest Month End (%)

	JANUARY '18 - JANUARY '19	JANUARY '17 - JANUARY '18	JANUARY '16 - JANUARY '17	JANUARY '15 - JANUARY '16	JANUARY '14 - JANUARY '15
MS INVF Global Credit Fund - Z Shares	-3.28	10.14	6.24	-4.55	2.43
Bloomberg Barclays Global Aggregate Corporate Index	-1.93	8.77	5.15	-3.92	2.66

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.
- 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 January 2019 and subject to change daily.

INDEX INFORMATION

The **Bloomberg Barclays Global Aggregate Corporate Index** is the corporate component of the Bloomberg Barclays Global Aggregate index, which provides a broad-based measure of the global investment-grade fixed income markets.

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

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