Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Global Fixed Income Opportunities 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 1.89% (net of fees)[1].

For the month, both macro and spread decisions contributed to performance. Positioning in credit sectors such as investment grade and high yield corporates contributed the most to performance, followed by rate exposure in developed markets. Broader emerging markets and government-related debt also contributed to performance. While not a detractor, positioning in securitized debt lagged in terms of contribution to performance. Exposure to Peruvian sol and Mexican peso was a detractor in the period.

Market Review

U.S., U.K. and German 10-year yields continued to fall in January by 6, 6 and 9 basis points (bps), respectively. Federal Reserve (Fed) Chairman Jerome Powell appeased investors early in the month, signaling to markets that the Fed will be patient with the timing of future rate hikes. Powell's tone set the stage for the rest of the month, quelling fears of tighter monetary policy. The 2-year–10-year Treasury yield spread remained relatively unchanged compared to levels seen at the end of December at approximately 17 bps, and the U.S. dollar (USD) saw broad-based declines against developed market and emerging market (EM) currencies.

In Europe, growth data continued to come in weaker than expected, particularly in Germany and Italy. The European Central Bank's (ECB) view remains that the economic weakness is likely to be transitory, and points to strong labor market data as a source of growth and inflation going forward. However, officials acknowledge things are not progressing as they envisioned and there is at least as much downside risk as upside. It seems increasingly unlikely the ECB will manage to raise interest rates this year; more targeted easing is very possible.

The U.K. continues to be driven by Brexit uncertainty. The risk of a 'no-deal' exit is increasing, as the planned March 29 exit date approaches, but it seems increasingly likely Parliament will force Prime Minister May to ask for an extension so that the exit can be negotiated in an orderly manner.

EM fixed income assets rebounded in January following a volatile 2018. Domestic debt led the way, driven by currency strength versus the USD and local bond performance. Within hard-currency assets, high yield outperformed investment grade, and sovereigns outperformed corporates. An improvement in EM sentiment was driven by attractive valuations, optimism around U.S.-China trade talks, the easing measures announced by the People's Bank of China in December and a growing perception that the U.S. Fed hiking cycle may be over. Commodity prices also rose, with double-digit returns registered for crude oil, followed by agricultural commodities and metals. Investment flows were positive, primarily into hard currency strategies, followed by local currency and blended strategies. Issuers took advantage of the favorable market backdrop to issue, with a variety of sovereign, quasi-sovereign and corporate deals priced during the month.

Global investment grade spreads rallied strongly in January, recouping all of December's underperformance. While economic data and corporate earnings have been weak in spots and unremarkable in others, spreads were simply too wide at the start of January for a non-recessionary environment. The Bloomberg Barclays U.S. Corporate Index narrowed by 26 bps in January to end the month at 127 bps over government bonds, with financials and BBB non-financial credits leading the market tighter. As measured by excess returns versus government bonds, the Bloomberg Barclays U.S. Corporate Index generated an excess return of +1.83% for the month. European investment grade lagged the U.S. market, but spreads also narrowed in January. Spreads on the Bloomberg Barclays Euro-Aggregate Corporate Index tightened by 10 bps to end January at 141 bps relative to government bonds.

After several months of a risk-off environment, mortgage and securitized markets stabilized in January. Mortgage and securitized spreads were slightly tighter but did not experience the more significant rebound that occurred in many other credit sectors in

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

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January. Returns in January came from a combination of interest rate movements, spread changes and cash flow carry. Both agency mortgage-backed securities (MBS) and credit-sensitive sectors had similar aggregate performances in January, but for different reasons. Rate movements largely propelled agency MBS performance, while carry dominated credit-oriented asset returns. Fundamental securitized credit conditions remain sound with low default rates, healthy consumer balance sheets and stable housing markets.

Portfolio Activity

During the month we added to developed markets rates in Spain, Australia, Greece and Saudi Arabia, as well as in EM debt, investment grade corporates and cash holdings. Conversely, we trimmed exposure to securitized debt.

Strategy and Outlook

What a difference a month makes. The extremely adverse market conditions in December were replaced by very supportive ones in January. Not only did the S&P 500 Index enjoy its best return month since October 2015, practically all asset classes delivered positive returns. The most obvious explanation for the turnaround is the change in tone from the Fed. In addition to dovish statements made by Federal Open Market Committee (FOMC) Chairman Powell, at the Fed's January meeting the Committee communicated it is likely to take a far more cautious path in raising rates further, if it raises rates at all.

The rally in many risky assets, e.g., small-cap equities, pre-dated the Fed statements. It would appear that many investors agreed with us that valuations were discounting an economic outcome that was far more severe than was likely to occur, and many assets had become too cheap unless a recession was imminent. Nonetheless, the shift in Fed tone was very important. It helped to reduce concerns that the Fed would tighten policy too far too quickly, and fits with a broader theme of central banks moderating or outright reversing their tightening policies. Subdued inflation in all the major economies means that central banks are under little pressure to tighten policy quickly, or to tighten at all. For example, the U.S. labor market reports for December and January both reported very healthy increases in employment. However, wage growth did not accelerate, and the unemployment rate rose as more workers joined the labor force. This suggests there is more slack in the U.S. economy and the Fed can be 'patient'.

On the whole, economic data released in January disappointed, with three notable trends. First, the survey 'soft' data tended to be weaker than the actual 'hard' economic data releases. Given that soft data tends to be less volatile than the hard data, and hence a better indicator of underlying economic trends, it may be flagging economic weakness that will soon become evident. Second, U.S. economic data have been considerably better, relative to expectations, than data for other economies, notably Europe. Third, the weak data have primarily associated with trade, manufacturing and investment. Household consumption has generally remained strong as unemployment is low and wage growth has been rising, albeit modestly. Generally, the fixed investment and manufacturing sectors, which are typically more volatile, drive the business cycle. If they continue to slow it could cause a broader economic slowdown. However, with household income growth solid in both the United States and Europe, a recession or even higher probabilities of recession look unlikely.

The shift in central bank policy expectations is important for our outlook on yields. We no longer think that the Fed and other central banks will tighten policy over the coming months. As a result we have turned neutral on duration. However, we expect some variation in performance across markets. We think Australian rates have the most potential to stay low or fall further, while we expect Canadian yields to rise more than in the U.S. In Europe, we think U.K. yields can rise considerably given the tight labor market once a resolution for Brexit is found.

We expect credit spreads to tighten across markets. Absent a recession, default rates are likely to stay low, company earnings will continue to grow and liquidity should return to the market. We think concerns about high yield markets being swamped by a deluge of downgraded BBB rated companies are overstated, as continued earnings growth will give them time to manage their debt profiles lower. However, while we continue to position portfolios long risk, we are taking advantage of the more supportive conditions to incrementally sell positions we feel are vulnerable to a deterioration in fundamentals.

The emerging market debt outlook we envisioned at the end of last year has materialized, for the most part, in the first month of 2019. At the time, we argued that attractive valuations, a backdrop of moderate global growth and subdued inflation, coupled with a dovish Fed and USD weakness would support EM debt assets in 2019. The strong year-to-date performance inevitably raises questions about the sustainability of the rally. We remain cautiously optimistic on EM fixed income, as the underlying premises of our investment thesis still apply, though valuations have become less enticing.

In securitized and mortgage markets, we still believe the U.S. economy remains strong with healthy consumer and real estate market conditions, and we remain overweight credit-oriented securitized investments. 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 ease.

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

FUND FACTS

Launch date
07 November 2011

Base currency
U.S. dollars

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 Fixed Income Opportunities Fund - Z Shares	1.12	8.10	7.19	-3.54	6.09

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**

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 **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.

The **Bloomberg Barclays U.S. Corporate Index** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market.

The **Bloomberg Barclays Euro-Aggregate: Corporates bond index** is a rules based benchmark measuring investment grade, EUR denominated, fixed rate, and corporate only. Only bonds with a maturity of 1 year and above are eligible.

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