Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Global High Yield Bond 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 3.72% (net of fees)[1], while the benchmark returned 4.10%.

Over the month, overweight positioning to capital goods and consumer cyclical names contributed positively to performance, driven primarily from building materials and diversified manufacturing. An underweight to both communications and technology detracted from returns as did security selection within utilities.

Market Review

Following the tumultuous market sell-off in December, January helped offset some of the losses that investors incurred in the fourth quarter. Sentiment moderated during the month, with the VIX falling below 17 for the first time in several months. 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 the markets that the Fed will be patient regarding 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 saw broad-based declines against developed market and emerging market currencies.

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 in financial conditions and a greater-than-expected negative impact from monetary policy tightening. Crucially, it communicated the next rate move may not be a hike.

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

In the U.K., Prime Minister Theresa 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 European Union (EU). Subsequently, Theresa 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 bp rate hike is now only priced to occur in the second half of 2020. Five-year gilt yields fell 3 bps to 0.87% and the 10-year fell 6 bps.

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

As expected, the European Central Bank (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 while Italy entered technical recession (two quarters of gross domestic product contraction) in the second half of 2018. Following Draghi's comments, the euro traded 0.5% lower against the U.S. dollar. The International Monetary Fund (IMF) 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 the eurozone dropped over the month, with Greece and Spain seeing the largest declines of 22 and 50 bps, respectively.

U.S. High Yield

Following a volatile December, U.S. high yield rebounded sharply amid a strong equity rally, rising oil prices and a dovish pivot by the Fed. Spreads snapped 100 bps tighter to end the month at +442 bps while yields declined 105 bps to 6.90%, recouping all of December's widening. This resulted in total returns of +4.52% for the Bloomberg Barclays U.S. Corporate High Yield Index.

From a ratings perspective, lower-quality bonds outperformed higher-rated credits. CCCs returned +5.29%, followed by Bs at 4.49% and BBs at 4.24%. At the sector level, all sectors were up in January with commodity-related sectors leading the way, as oil was up 18% month-over-month. The best performing sectors were oil field services (+7.06%), exploration & production (+7.00%) and pharmaceuticals (+6.36%). Conversely, the worst performing sectors were aerospace/defense (+2.92%), media entertainment (+3.08%) and financial other (+3.33%), which underperformed largely due to negative credit-specific developments.

Following no new issuance in December, the U.S. high yield market priced $16.6 billion in U.S. dollar-denominated bonds this month, which was more than double the prior two months' combined issuance. There were no defaults in January, and we expect high yield bond defaults to remain modest and track below long-term averages.

European High Yield

January saw a drift wider in credit spreads over the first few days of the month, followed by a sharp rally back to November spread levels. The iTraxx Crossover, a gauge of market sentiment, ended the month at 310 bps, roughly 42 bps tighter, and index option-adjusted spreads were 66 bps tighter at 456 bps.

The best performing sectors for the month were food & beverage and pharmaceuticals. Despite the strong rally, cyclicals continued to get hit, with metals & mining and autos as the worst performing sectors.

The January primary pipeline, which has historically been robust, was muted. A selection of small add-on or mirror deals tested the waters and generally performed well on the break. For those deals where book size was made public, demand was strong. The asset class also saw inflows over the course of the month, which further supported the technical for the asset class.

Portfolio Activity

We remain focused on middle market-sized credits and continue to be overweight transports, building materials and food & beverage. We continue to remain underweight communications, a sector that tends to have the lowest coupon and longest duration capital structures.

Strategy and Outlook

Despite the recent volatility, our base case remains that a recession is not imminent and that high yield remains an attractive asset class on relative value. Valuations began the year at multi-year highs and priced in a lot of bad news. However, we believe that the economic outlook is for economies to just grow more slowly, but not collapse. Economic growth expectations in the U.S. remain positive at 2.5%, and weak inflation limits the pressure on central banks to tighten policy quickly. Furthermore, central banks have noticed the deceleration in economic activity and have become considerably more dovish. Most prominent is the shift at the Fed, which after raising rates eight straight quarters, may not raise interest rates at all in 2019. This significantly reduces the risks of a 'hard landing' to the U.S. economy due to the Fed overtightening. We think that moderate growth, stable inflation and a patient Fed is an excellent recipe for engineering a soft landing for the U.S. economy and welcoming back good performance for risky assets.

We expect spreads to tighten across markets, default rates to stay below historical averages and company earnings to continue to grow. Continued earnings growth will give BBB rated companies time to manage their debt profiles, and we see the risks being overstated on the number of expected downgrades to BB (we would note corporates have the ability to reduce dividends, sell businesses and reduce leverage through retained earnings). Given all of this, we feel that markets have overshot, and with spreads around +450 bps and index yields approaching 7% in the U.S., we think valuations are compelling.

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

FUND FACTS

Launch date	Base currency	Index
18 November 2011	U.S. dollars	Bloomberg Barclays Global High Yield - 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 High Yield Bond Fund - Z Shares	-2.52	9.69	17.56	-4.35	-3.35
Bloomberg Barclays Global High Yield - Corporate Index	-0.87	9.81	17.97	-5.75	-0.78

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 High Yield- Corporate Index:** is a multi-currency measure of the global high yield corporate debt market.

The Bloomberg Barclays U.S. Corporate High Yield Index is a multi-currency measure of the global high yield corporate debt market.

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