Performance Review

In the one month period ending 31 August 2020, the Fund’s Z shares returned 1.98% (net of fees)\(^1\), while the benchmark returned 1.40%.

This brings year-to-date performance for the Fund’s Z shares to -0.78% (net) versus the index, which returned 2.34%.

Looking at the high yield market as a whole, it has now retraced almost all of the spread widening. Year-to-date returns for the Bloomberg Barclays Global High Yield Corporate Index are now positive after being down over 20% in mid-March, and spreads are now inside of 500 basis points (bps) after gapping out as wide as 1,100 bps.\(^2\) Large exchange traded fund (ETF) eligible names and fallen angels have rallied back and recovered in record time.

However, the middle-market space has lagged on the recovery and, although this is typical, this technical has been exacerbated by the Federal Reserve’s (Fed) move into high yield. While large ETF names had been the early outperformers of the rally, smaller second-tier names have been moving higher as many of the larger ETF names trade very tight (many coming to market yielding less than 4%), and investors are looking for remaining value. Given this, the portfolio’s performance also continues to recover.

The portfolio’s positioning in capital goods, particularly its overweights to building materials and diversified manufacturing, contributed positively to returns, as did the portfolio’s overall energy exposure. Overweights to media & entertainment and gaming were also additive. This was partially offset by underweights to airlines, autos and banking, which detracted from returns.

Market Review

Risky assets continued to rally in August as economic activity continued to pick up, despite a further spike in cases across the U.S. and other parts of the developed markets. The U.S. dollar weakened against a backdrop of steepening sovereign yield curves and dovish tones from central banks. Inflation expectations globally continued to recover, with U.S. 10-year Treasury inflation-protected securities (TIPS) breakevens in particular widening a further 25 bps, to their widest level since early 2019.

In the U.S., the July Federal Open Market Committee (FOMC) meeting minutes were released and the annual Jackson Hole symposium was held. The FOMC meeting minutes from July painted a dovish picture: the Fed will continue “fostering accommodative financial conditions and supporting the economic recovery”. At Jackson Hole, Fed Chairman Jerome Powell announced an overhaul of the Fed’s monetary policy framework and the adoption of an average inflation targeting regime. Within this new framework, the Fed will tolerate a deviation of inflation above 2% in order to make up for periods when inflation was below 2%, such that inflation “averages” 2%.

The Bank of England (BoE) left rates and its bond purchasing program unchanged. BoE Governor Bailey stated negative rates are part of their toolbox, but they do not currently have a plan to use them. The Monetary Policy Committee noted that the economic recovery to date has been stronger than originally expected. Nonetheless, given very high economic uncertainty, policy makers are reluctant to assume this means a better economic trajectory going forward. They forecast economic activity will only return to its fourth quarter 2019 level by the end of 2021 and remain concerned about unemployment. The BoE further emphasized its belief that businesses and households will need continued support from the financial sector and government.

In Japan, Prime Minister Shinzo Abe said on August 28 that he would resign due to poor health; however, this had little impact on the Japanese government bond market, as Bank of Japan policy should remain unchanged in order to deal with the market and economic impacts of the pandemic.

\(^{1}\) Source: Morgan Stanley Investment Management Limited. Data as of 31 August 2020.

\(^{2}\) Source: Bloomberg Barclays. Data as of 31 August 2020.

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U.S. High Yield

The recovery in high yield bond prices extended in August, and spreads and yields fell across the board amid better-than-feared earnings. The Bloomberg Barclays U.S. Corporate High Yield Index produced total returns of 0.95% in August, bringing year-to-date returns to 1.67%. Since March 23, the index has returned 26.7%. Over the month, spreads tightened 11 bps to 477 bps, which is 623 bps tighter since the March wides, and yields declined 3 bps to 5.34% compared to the March highs of 11.69%.

In contrast to July, when the rally was led by higher-quality bonds, lower-quality bonds outperformed in August. On a total return basis, CCC rated bonds returned 1.98%, followed by B and BB rated bonds, which gained 0.96% and 0.61% respectively. On a year-to-date basis, higher-quality bonds are significantly outperforming lower-quality credit, with BBs generating 5.74%, followed by Bs and CCCs, which are still in negative territory (-0.24% and -74.0%). Overall, the high yield index continues to move up in quality, driven by fallen angels and a pick-up in realized defaults. BBs now represent 55% of the high yield index, which is an all-time high.

From an industry perspective, most sectors were up in August, and the market continues to experience beta compression. As a result, some of the best-performing sectors in August included some of the hardest-hit sectors earlier in the year. Airlines (+6.35%), leisure (+3.64%) and restaurants (+2.87%) were the top three performing sectors, while the worst-performing sectors were oil field services (-5.45%), health insurance (-0.76%) and aerospace/defense (-0.66%).

The new issue calendar continues to be robust and has provided companies with access to capital to shore up liquidity. Gross supply for the month was $54.3 billion, making it high yield’s third-highest month on record. This brings year-to-date new issue volume to $299.4 billion, or $111.3 billion net of refinancing. Although the market has seen record issuance, CCC issuers continue to struggle to access the market and have not benefited from the overall high yield market reopening. However, we believe the limited funding in lower-quality issuance is expected to improve going forward.

New issue was absorbed well by the market, as high yield continues to see record inflows. High yield mutual funds and ETFs experienced month-to-date inflows of $8.0 billion and year-to-date inflows of $41.9 billion, according to Lipper.

The Fed continues to make use of the secondary market corporate credit facility (SMCCF), which now stands at $12.8 billion across ETFs and bonds. However, according to the latest transaction report, released on August 10, the pace of the Fed’s purchases has slowed. The SMCCF went from an average daily purchase of $158 million in the first week of July to just $20 million per day in the last week of July. By month, average SMCCF weekly purchases are as follows: May $143 billion, June $144 billion, July $568 million, August $108 million. By ratings, roughly 90% of the Fed’s purchases have been investment grade, versus just 10% in high yield. We believe the consistent reduction in the SMCCF’s daily purchase pace is a function of both improving market conditions and summertime liquidity.

Only three companies defaulted in August, with volume totaling $1.6 billion in bonds and loans. Through the first eight months of the year, 88 companies have defaulted, totaling $122.9 billion in bonds and loans. The year-to-date default total of $122.9 billion, inclusive of distressed exchanges, ranks as the second-highest annual default total on record and only trails the $205.0 billion that occurred in 2009.

European High Yield

August was another strong month for European high yield, with the index option-adjusted spread ending the month 53 bps tighter at 443 bps, in a steady grind that picked up in the last two weeks of August. There was a pick-up in default activity, with default rates now slightly above 2%; however, on average, recovery values have been higher than expected at the secured level, and certainly higher than in 2019, which has been supportive for lower-rated and stressed securities.

In stark contrast to the U.S., primary issuance was non-existent, with no core high yield new issues in the month (AT1 bonds and corporate hybrids excluded). This, combined with the continued steady trickle of flows back into the asset class, has been supportive for the technical.

Portfolio Activity

We have been actively participating in the new issue calendar, which continues to present attractive opportunities. We have had added some higher-quality fallen angels and sold several credits that we deemed to be near-term default risk.

Strategy and Outlook

We expect to see a meaningful increase in overall defaults in the coming year due to a significantly weaker economy stemming from the outbreak, as well as stress in the energy sector. Default rates have ticked up to a 10-year high, and current street estimates vary between 8% and 10% going forward. We expect all to be heavily concentrated in energy and coronavirus-impacted sectors, so getting sector positioning right will be critical for performance over the coming months. We believe energy could account for half or more of the defaults in the U.S. market.

The focus for July was the beginning of the second-quarter earnings season, where results are coming in line with expectations or, in some cases, better than expected. This should be supportive for high yield credit spreads in the near term; we are

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therefore positioned for compression. The next big catalyst for companies will be third-quarter operating performance, which will confirm the speed and slope of the recovery. As ever, security selection will be paramount in avoiding the losers and picking the survivors.

While July and the second quarter generated stellar returns, an alarming rise in infection rates in several large U.S. states and outbreaks in countries exiting lockdowns risk backsliding on the economy. The U.S. presidential election and U.S.-China relations represent another set of issues independent of the pandemic. On the positive side, progress on vaccines and therapeutics could generate upside economic and financial surprises. We also continue to expect monetary policy to remain accommodative and risk assets to be well supported across developed markets in the coming months, in order to support the continued stabilization of the global economy and financial markets. There is lots to think about, but we remain optimistic that high yield will continue to move tighter over the longer term; however, some spread widening could materialize as we head closer to the November election.

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

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Share Class Z Risk and Reward Profile

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 is 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.

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