Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Investment Funds

Global Mortgage Securities Fund

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MONTHLY COMMENTARY | 30 NOVEMBER 2017

PERFORMANCE REVIEW

In the one month period up until the 30 November 2017, the fund's Z shares returned 0.22% (net of fees)[1] while the benchmark returned -0.14%.Year-to-date through November 30th, the fund's Z share class returned [7.10%] while the benchmark returned 2.14%.

Allocations to credit-related sectors, most notably European residential mortgage-backed securities (RMBS) and U.S. non-agency RMBS, were the primary reasons for outperformance during the month. Our U.S. commercial mortgage-backed securities (CMBS) and U.S. asset-backed securities (ABS) positions also made positive contributions to performance in November, while our U.S. agency mortgage-backed securities (MBS) positions had a slightly negative return for the month, but still outperformed the Index.

MARKET REVIEW

Agency MBS generated slightly negative returns as interest rates increased in November, with the Bloomberg Barclays Mortgage Index returning -0.14% for the month, performing in-line with the Bloomberg Barclays U.S. Treasury Index - which also returned -0.14% for the month. Year-to-date, the Bloomberg Barclays Mortgage Index has outperformed the Bloomberg Barclays U.S. Treasury Index by 14 basis points. Nominal spreads on current coupon agency MBS tightened 3 basis points in November to 77 basis points above interpolated Treasuries, while the option-adjusted spread (OAS) was 1 basis point wider at 12 basis points above interpolated Treasuries. The U.S. Federal Reserve (Fed) purchased roughly $22 billion agency MBS in November and maintained its agency MBS portfolio at $1.77 trillion. The Fed announced in its September Federal Open Market Committee (FOMC) Statement that it "will initiate the balance sheet normalization program" in October, however we have not seen any balance sheet reduction over the past two months. We still expect the Fed to begin reducing its MBS purchases in the coming months.

Non-agency MBS spreads were essentially unchanged in November, while cash flow and credit performance continued to improve. Fundamental U.S. housing market and mortgage market conditions remain positive. National home prices were up 0.4 percent in September, and are up 6.2 percent over the past year, the biggest yearly increase since 2014. Home prices are up 45.9 percent nationally from the lows in 2012, and are now up 6.0 percent from the pre-crisis peak in July 2006. Existing home sales increased 2.0 percent in October from September 2017, but were down 0.9 percent from October 2016. Available housing inventory decreased 3.2% in October and is now 10.4% lower than a year ago, and is lower year-on-year for the 29th consecutive month. Unsold inventory is at a 3.9 month supply at current sales pace in October, down from the 4.4 month supply a year ago. Despite the recent increases in home prices, U.S. homes remain 9% more affordable, when comparing median incomes against the cost of owning a median priced home, than the 20-year historical average. Mortgage performance also remains strong. New mortgage defaults increased slightly to a 0.67% annual default rate in October, but remain near the lowest levels over the past 10 years. With unemployment low, the economy slowly strengthening, and homes remaining generally affordable at current mortgage rates, we expect mortgage credit performance to continue to improve.

FUND FACTS

Fund launch
03 December 2012

Investment team
Greg Finck, Neil Stone

Base currency
U.S. dollars

Benchmark
Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index

[1] Source: Morgan Stanley Investment Management Limited. Data as of 30 November 2017.

CMBS performance continues to diverge based on collateral type, with CMBS backed by retail properties trading poorly and CMBS backed by most other collateral types generally performing well. In aggregate, CMBS spreads tightened slightly in November, and AAA CMBS are roughly 20 basis points tighter on the year, while BBB- CMBS are roughly 50-60 basis points tighter year-to-date. Non-agency CMBS issuance totaled roughly $8 billion in November, lifting the 2017 year-to-date total to $79 billion for the first eleven months of 2017. We expect CMBS new issuance to slow meaningfully in 2018 as fewer CMBS deals are maturing from the significantly smaller 2008-vintage CMBS origination. Fundamentally, CMBS performance remains on reasonably solid ground, although there are some areas of concern. Commercial real estate prices fell 1.1% in October, and are 0.9% lower in 2017. After several years of 10+ percent annual increases, commercial real estate prices have flattened over the past year, but we do not expect price changes to turn materially negative given the continued strength of the U.S. economy. Hotel occupancy rates increased again in September to 69.7%, up from 68.8% in September 2016. National office vacancy rates declined 0.1% to 12.9% in Q3 2017, essentially the lowest vacancy levels seen since Q1 2008. Suburban vacancy rates decreased 0.2% to 14.1% while downtown vacancy rates declined 0.1% at 10.6%. Multi-family vacancy rates increased 0.1% to 4.5% nationally in Q3 2017, and vacancy rates are now 0.4% higher year-on-year as new construction has exceeded net absorption rates. Retail shopping centers remain a major area of concern. Mall vacancy rates increased 0.2% to 8.3% in Q3 2017, and up 0.5% from Q3 2016. New construction of malls fell to the lowest levels since 2014, but net absorption of retail space fell even more to the lowest levels since 2010. We remain very cautious on CMBS collateralized by retail properties and by newly originated hotel loans, which have appreciated sharply over the past several years. We remain constructive on seasoned CMBS and newly issued CMBS backed by office buildings, residential properties and industrial properties.

European MBS spreads were largely unchanged in November, but remain 30 to 100 basis points tighter in 2017. Low interest rates and moderate signs of economic growth in Europe seem to be outweighing any material concerns over the potential fallout from Brexit. The ECB increased its ABS purchases again in October, and its ABS portfolio increased by €0.6 billion to €24.7 billion of European ABS as of the end of October 2017. European ABS issuance was steady in November with €11.6 billion issued during the month for a 2017 year-to-date total issuance volume of €77.8 billion, less than the €83.6 billion during the first eleven months of 2016. We expect securitized issuance to remain slower for the remainder of 2017 given the continuation of regulatory constraints.

PORTFOLIO ACTIVITY

We continue to add short duration credit-related securitized assets to the portfolio. With short- term interest rates rising and both the interest rate forward curve and the credit curve flattening over the course of the year, short duration credit-related assets offer attractive cashflow- and carry-based returns, with less mark-to-market risk if spreads were to widen or rates were to rise in the future. Fundamental real estate and consumer credit conditions remain generally positive, and we do not anticipate any near-term credit concerns for most securitized sectors, but we also believe that spreads are not likely to tighten materially further from current levels and could give back some of the spread tightening gains realized this year. The fund's duration and spread duration are currently roughly a year shorter than the index, but we are focused on maintaining attractive cashflow-based carry within the portfolio. During November, we reduced our U.S. agency MBS and U.S. CMBS positions, and added to our U.S. non-agency RMBS and U.S. ABS. We continue to be concerned about the impact of the impending Fed "balance sheet normalization" and its potential impact on agency MBS valuations. Within CMBS, we continue to trim CMBS exposures with higher potential credit risk. The CMBS market remains bifurcated with securities backed by hotels, office buildings and rental housing performing very well, while CMBS with greater retail exposure continues to underperform.

STRATEGY AND OUTLOOK

As 2017 comes to a close, we expect continued outperformance by securitized assets. While we do not expect further spread tightening, the fundamental conditions in the securitized markets remain positive, and the cash flow based carry of securitized assets should continue to generate compelling returns. Home prices continue to rise, consumer confidence and consumer balance sheets are improving, interest rates remain historically low and stable, and despite the political gridlock in DC, the lending environment is beginning to improve - with easing regulatory enforcement and expanding lending guidelines. These conditions bode well for further improvements in credit performance. We expect to see residential mortgage delinquencies and defaults continue to decline, commercial mortgage refinancing rates to continue to increase (with probable exception of retail shopping centers), and consumer-oriented ABS assets to continue to perform well. While spreads have tightened over the past year, most credit-related securitized spreads remain meaningfully wider than pre-crisis levels and are still wider than similarly-rated corporate credit investments. We expect securitized assets to continue to generate attractive absolute and relative carry-based returns in December and into 2018 as well.

What concerns us? The biggest risk we see in the near-term is a potential shock in interest rates. We expect that the Fed will likely raise short-term interest rates another 25 basis points in December, and simultaneously, the Fed has embarked on its "balance sheet normalization", effectively an unwind of its quantitative easing policies by slowing the pace of reinvestment of MBS and Treasuries and letting its portfolio slowly decline. The markets seem to be largely ignoring this potential risk, as longer term interest rates have hardly reacted to the Fed rate hikes over the past two years or to the announcement of its balance sheet normalization plans.   We believe the securitized markets can easily withstand a 50-100 basis point interest rate increase, but if mortgage interest rates were to rise more than 100 basis points from current levels, these higher rates could create some problems for mortgage affordability and refinance-ability.

In terms of relative value, we still favour a credit-oriented portfolio composed of non-agency RMBS, CMBS backed by non-retail properties, and some non-traditional ABS over more rates-related risk assets such as agency MBS. Non-agency MBS should continue to benefit from improving cash flows as defaults decline and voluntary prepayments increase. Spreads will not likely tighten much further from current levels, but non-agency MBS yields still offer compelling relative value and risk profiles continue to improve with rising home prices. Most non-retail CMBS sectors continue to perform well from a fundamental value perspective, with record high occupancy rates and increasing rental rates. Retail-related CMBS continues to suffer from store closings causing rising vacancy rates and weaker leasing rates. We also have some concerns about current valuations on some hotel and office properties, but remain constructive on housing-related CMBS. In non-traditional ABS, we continue to like housing-related ABS and subprime auto ABS, and we have been cautiously adding consumer loan ABS and aircraft lease ABS.

Agency MBS remains our least compelling sector. Agency MBS nominal spreads are at the tightest levels in more than 20 years, and the Fed is just beginning to reduce its $1.77 trillion agency MBS portfolio. Agency MBS option-adjusted spreads (OAS) are at more historically normal levels, but these OAS valuations are predicated on continued low interest rate volatility and low prepayment volatility. We believe that volatility will likely increase in 2018 as the Fed continues its rate hike program and advances its balance sheet reduction goals.

In Europe, we continue to favour seasoned U.K. RMBS and seasoned peripheral Eurozone RMBS. Home prices have been steadily climbing throughout Europe over the past few years supported by accommodative ECB policies of low interest rates and asset purchases. Many European housing markets remain below pre-crisis levels, and still have further room to recover. In the U.K., while we have significant concerns about the impact of Brexit on the U.K. economy and housing markets, we also believe that very seasoned (~10 years or more) U.K. RMBS will continue to perform well and should benefit from de-levering capital structures (increasing structural credit support levels). We believe the current risk premiums (spreads) that we receive on many of these seasoned U.K. RMBS overstate the actual risks on these seasoned securities. We continue to have an overweight to this sector.

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

12 Month Performance Periods to Latest Month End (%)

	NOVEMBER '16 - NOVEMBER '17	NOVEMBER '15 - NOVEMBER '16	NOVEMBER '14 - NOVEMBER '15	NOVEMBER '13 - NOVEMBER '14	NOVEMBER '12 - NOVEMBER '13
MS INVF Global Mortgage Securities Fund - Z Shares	7.14	4.82	2.36	7.57	-
Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index	2.14	1.64	1.70	5.42	-

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 higher the category (1–7), 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 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.
- 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 30 November 2017 and subject to change daily.

INDEX INFORMATION

The **Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index** tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage. 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 benchmark name changed from Barclays U.S. Mortgage Backed Securities (MBS) Index to Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index on 24th August 2016.

DISTRIBUTION

This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations. In particular, the Shares are not for distribution to US persons.

United Kingdom: Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA, authorised and regulated by the Financial Conduct Authority. **Dubai:** Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158). **Germany:** Morgan Stanley Investment Management Limited Niederlassung Deutschland Junghofstrasse 13-15 60311 Frankfurt Deutschland (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** Morgan Stanley Investment Management Limited, Milan Branch (Sede Secondaria di Milano) is a branch of Morgan Stanley Investment Management Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), and whose registered office is at 25 Cabot Square, Canary Wharf, London, E14 4QA. Morgan Stanley Investment Management Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 08829360968. **The Netherlands:** Morgan Stanley Investment Management, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of Morgan Stanley Investment Management Limited. Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Switzerland:** Morgan Stanley & Co. International plc, London, Zurich Branchl Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41 (0) 44 588 1074.

Australia: This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act. **Hong Kong:** This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This document should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"), (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. In particular, for investment funds that are not authorized or recognized by the MAS, units in such funds are not allowed to be offered to the retail public; any written material issued to persons as aforementioned in connection with an offer is not a prospectus as defined in the SFA and, accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply, and investors should consider carefully whether the investment is suitable for them.

IMPORTANT INFORMATION

EMEA: This marketing communication has been issued by Morgan Stanley Investment Management Limited ("MSIM"). Authorised and regulated by the Financial Conduct Authority. Registered in England No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

This document contains information relating to the sub-fund ("Fund") of Morgan Stanley Investment Funds, a Luxembourg domiciled Société d'Investissement à Capital Variable. Morgan Stanley Investment Funds (the "Company") is registered in the Grand Duchy of Luxembourg as an undertaking for collective investment pursuant to Part 1 of the Law of 17th December 2010, as amended. The Company is an Undertaking for Collective Investment in Transferable Securities ("UCITS").

Applications for shares in the Fund should not be made without first consulting the current Prospectus, Key Investor Information Document ("KIID"), Annual Report and Semi-Annual Report ("Offering Documents"), or other documents available in your local jurisdiction which is available free of charge from the Registered Office: European Bank and Business Centre, 6B route de Trèves, L-2633 Senningerberg, R.C.S. Luxemburg B 29 192. In addition, all Italian investors should refer to the 'Extended Application Form', and all Hong Kong investors should refer to the 'Additional Information for Hong Kong Investors' section, outlined within the Prospectus. Copies of the Prospectus, KIID, the Articles of Incorporation and the annual and semi-annual reports, in German, and further information can be obtained free of charge from the representative in Switzerland. The representative in Switzerland is Carnegie Fund Services S.A., 11, rue du Général-Dufour, 1204 Geneva. The paying agent in Switzerland is Banque Cantonale de Genève, 17, quai de l'Ile, 1204 Geneva. The document has been prepared solely for informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy.

Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

The views and opinions expressed are those of the portfolio management team at the time of writing/of this presentation and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. These comments are not representative of the opinions and views of the firm as a whole. Holdings, countries and sectors/region weightings are subject to change daily. All information provided is for informational purposes only and should not be deemed as a recommendation to buy or sell securities in the sectors and regions referenced. Information regarding expected market returns and market outlook is based on the research, analysis, and opinions of the team. These conclusions are speculative in nature, may not come to pass, and are not intended to predict the future of any specific Morgan Stanley Investment Management investment. Past performance is no guarantee of future results.

All investments involve risks, including the possible loss of principal. The material contained herein has not been based on a consideration of any individual client circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the applicable European or Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary. If you are a distributor of the Morgan Stanley Investment Funds, some or all of the funds or shares in individual funds may be available for distribution. Please refer to your sub-distribution agreement for these details before forwarding fund information to your clients.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without MSIM's express written consent.

All information contained herein is proprietary and is protected under copyright law.

This document may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this document in another language, the English version shall prevail.