Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Global Multi-Asset Income Fund

SOLUTIONS AND MULTI-ASSET | GLOBAL MULTI-ASSET TEAM | MONTHLY COMMENTARY | 31 JULY 2019

Performance Review

In the one month period up until 31 July 2019, the Fund's Z shares returned 2.09% (net of fees)[1], while the benchmark returned 2.18%.

Global bonds returned +2.0% in July (Barclays Global Aggregate Bond Index, EUR), while global equities returned +2.6% (MSCI All Country World Index, EUR).[2] High yielding assets returned +0.4% (equal weighted in EUR: Dow Jones Brookfield Global Infrastructure Index, FTSE EPRA/Nareit Developed Total Return Index, Barclays Global High Yield Index, JP Morgan EMBI Global Total Return Index).

The Fund underperformed its custom benchmark, the Global Multi-Asset Income Benchmark, which returned +2.2%. The Fund's asset allocation mix of an underweight to global equities, an overweight in global fixed income and an equal weight in high yielding assets had a negative effect on performance. Among the GMA Team's thematic exposures, contributors to performance included an overweight position in Australian vs. U.S. rates, overweight positions in Turkish bank stocks and the lira, and an overweight in the Brazilian real. Detractors included overweight positions in midstream energy stocks and U.S. health care stocks, as well as an overweight in eurozone domestic stocks, all vs. U.S. equities. Underweight positions in the U.S. dollar vs. developed market defensive currencies also detracted.

The strategy's underlying options exposures generated income during the month in line with its targeted income levels, and options positions held as part of the Fund's income enhancement strategy were a positive contributor to performance.

Market Review

Global growth data appeared to indicate stabilization. Global flash all-industry PMIs ticked up from 50.9 in June to 51.1 in July (since revised up to 51.3). This still implies a sub-trend growth rate of 2.4-2.5%. Global equities continued to rise modestly in July, up 0.9% in local FX. Regionally, U.S. equities led (S&P 500 Index +1.4%) and emerging market (EM) equities lagged (MSCI EM Index in USD -1.0%).

Inflation continued to disappoint expectations in many economies, and central banks continued to cut rates globally. In the U.S. despite a strong employment report for June (jobs +224,000 vs. +160,000 expected by consensus), wage pressures failed to materialize: average hourly earnings were 3.14% year-over-year vs. consensus expectations for 3.2%. Australia, Indonesia, Korea, Russia, South Africa, and Turkey lowered policy rates in July. With inflation remaining below target in most major economies and continuing to decelerate in many emerging ones, we expect global monetary policy to ease further.

The U.S. Federal Reserve (Fed) delivered a "hawkish" -25 basis point cut at its 31 July meeting, causing risky assets to sell off in response. Expectations of a dovish Fed had underpinned a risk rally over the past two months amid mixed growth data. The market's expectation for rate cuts in 2019 went from 2.7 as of mid-July to 1.3 following Chairman Powell's press conference. The U.S. 10-year Treasury yield was little changed at 2.01%, but the 2-year yield rose by +12 basis points to 1.87% flattening the yield curve. The U.S. dollar rose 2.5%, gaining the most vs. the British pound (-4.2%), the Argentine peso (-3.0%) and the euro (-2.6%).

Italy and the European Union (EU) agreed to a fiscal compromise, helping Italian yields fall -56 basis points to their lowest levels in over a year. Current International Monetary Fund (IMF) Chief Christine Lagarde's nomination as Draghi's successor at

1 Source: Morgan Stanley Investment Management Limited. Data as of 31 July 2019.
2 Currency (FX) abbreviations used in this report are: EUR = euro, USD = U.S. dollar

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the ECB was a status quo outcome and suggests a continuation of accommodative policies. German 10-year bund yields fell by a further -11 basis points to -44 basis points.

Portfolio Activity

We initiated overweight positions in U.S. value stocks vs. U.S. momentum stocks, and in eurozone value stocks vs. eurozone quality stocks. Based on our composite measure of fair value, U.S. value stocks trade at a 55% discount to U.S. momentum stocks while eurozone value stocks trade at a 51% discount to eurozone quality stocks. From these levels of discount, historically value stocks have outperformed momentum stocks by 30% in the U.S. and quality stocks by 16% in the eurozone over the next 12 months.

We also initiated an overweight position in U.S. bank stocks relative to U.S. equities, as we believe that U.S. banks have overpriced the risk of slowing U.S. and global growth. U.S. banks are trading at a 44% discount to the market on forward earnings (20% below the historical average), while earnings continue to keep pace with the broader market.

We increased our overweight in the Brazilian real vs. the U.S. dollar and a basket of Latin American currencies. We continue to believe that pension reform will unlock value for investors, and momentum appears to be building for a tax reform bill as well. We modified and increased our overweight in Argentine 10-year U.S. dollar-denominated external sovereign bonds by hedging broader rates exposures (using U.S. 10-year Treasuries and emerging markets credit default swaps). We reduced our overweight in the Argentine peso vs. a basket of emerging market currencies.

We closed our underweights in the U.S. dollar vs. developed market domestic currencies, as recent economic releases have indicated that the convergence we were expecting between the U.S. and European/global growth has played out. We also closed our underweights in U.S. equities and overweights in German vs. global equities, as well as an overweight in U.S. health care vs. defensive stocks.

Strategy and Outlook

Just as the global economy and markets were attempting to recover from the tariffs that have been implemented since 2018 and the Fed's 2018 monetary policy tightening, the world received news of a new round of tariffs via tweet: the U.S. would impose 10% tariffs on the remaining $300 billion in imports from China starting 1 September, unless significant progress was made in trade negotiations before then. Since then, the U.S. has announced a delay in tariffs on $156 billion of those products until 15 December 2019. In this letter, we detail how these new tariffs cause a downgrade to our forecasts for global and U.S. GDP growth, inflation and earnings growth, and what assets may have over- or under-priced this fundamental development.

Impact on our global growth, inflation, and earnings forecasts.

Before this latest tariff announcement, given fading 2018 U.S. fiscal stimulus, Fed rates hikes, and prior rounds of tariffs, we had expected global growth would slow to 2.5% by year-end from 3.25% in 2017-18, before rebounding to a trend-like pace of 2.7% in 2020. We had expected U.S. growth to slow to 1.8% by year-end 2019 before rebounding to 2.0% in 2020, with U.S. inflation slowly climbing to 1.8% in December 2019 and 1.9% in December 2020. In that context, we had expected profits growth would slow to 6% in 2019 globally before rebounding to 8% in 2020, while U.S. profits growth remained at 1% for 2019-20.

With the new tariffs to be implemented in September and December, we lower U.S. and global growth by 20 basis points each. We now expect global growth to dip further into subpar territory at 2.3%, with the U.S. falling as low as 1.6%. These lowered growth estimates hit underlying U.S. inflation modestly, though core inflation will likely still climb to 1.8-1.9% by year end, because goods prices will reflect a pass-through of higher tariffs. Compared to prior rounds of tariffs, the latest tranche includes a higher share of consumer goods relative to intermediate or capital goods. Global profits in 2020 will also feel a modest hit from the latest round of tariffs, growing only 5% (or -1% in the U.S.). Our 2020 estimates are approximately 2-5% below consensus.

There are of course downside risks to these estimates.

- First, the U.S. has threatened an additional 15% tariff on the $300 billion tranche of Chinese imports in order to get China back to the negotiating table. We estimate that this would reduce global and U.S. GDP growth by another 30 basis points over a 12-month period and reduce global earnings per share (EPS) by another 2-4%.

- Second, the trade war could escalate into a currency war, introducing more uncertainty for exporters and importers as well as for financial markets. Even without a currency war, the shock of the 10% tariffs (and possible additional 15% tariffs)

could have a non-linear impact on global economic growth, particularly as the cushion from U.S. fiscal stimulus and previously low interest rates has disappeared.

- Third, China is trying to engineer a soft landing for the fourth time since 2007: the previous three were bumpy but ultimately successful. This came at the expense of a huge buildup in debt, financial risk, and excesses in the property market. As a result, the current easing stance of the Chinese authorities strikes us as much more cautious and, given the likely diminishing returns of returning to the well for the fourth time, it is possible that this time the Chinese economy does not soft land but hard lands. This is not in our base case for China, but we do expect a continued deceleration in growth.

- Finally, a less appreciated aspect of the latest global trade slowdown is that it started before the trade war tweets in mid-2018 and appears to have been driven, according to researchers at the Bank of International Settlements (BIS), by a tightening in U.S. dollar liquidity for banks that finance trade globally. This would imply that until the Fed eases by enough to weaken the U.S. dollar, the trade drag could continue or even worsen with potentially negative consequences for exporters globally.

There are of course upside risks to consider as well.

- First, most estimates of the impact of tariffs on economic growth and inflation, including ours, have a high degree of uncertainty, particularly concerning the indirect impacts of tariffs, and thus could overstate them.[3]

- Second, policy actions could offset some of these negative impacts. For example, in 2018, the U.S. implemented a $12 billion aid package for farmers impacted by disruptions in trade. A second $16 billion package will be disbursed in the third and fourth quarters of this year. These two aid packages should fully offset the $10 billion drop in U.S. agricultural exports to China in 2018. In addition, further rate cuts by the Fed could cushion the economic uncertainty caused in part by trade, particularly compared to the rate tightening path expected by the market nine months ago. Similarly, Chinese and eurozone policy makers could decide to implement more forceful stimulus.

In sum, our downgraded growth forecasts represent our best estimates of the impact of known factors on the economy but are subject to both upside and downside risk. We next review what has been priced in by major asset classes and where investment opportunities may lie.

Market pricing and investment opportunities: Stocks vs. bonds

Based on our tactical measures of value, global stocks appear to have priced in not only the soon-to-be-implemented tariff on $300 billion in imports, but also most of the threatened 15% increase on that tranche, which would bring the total tariff to 25% on all goods imported from China. We estimate that the global equity risk premium is nearly 5.0% today.[4] Based on our models, a 5.0% equity risk premium implies a global growth rate of 2.0%. As discussed above, the latest 10% tariffs led us to downgrade growth to 2.3% by year-end. Thus, equities have slightly overpriced the slowdown that we expect (2.0% growth priced in vs. 2.3% growth forecast). It is not unusual for markets to overshoot "fair value," and it implies that stocks have discounted that the additional 15% tariffs on $300 billion will be implemented, driving growth to 2.0%. If our 2.3% assumption for global growth is correct, stocks could have 8% outperformance potential relative to bonds—and 14% if growth rebounds to 2.5% in 2019.[5] Note that a significant portion of this upside in stocks relative to bonds may come from bond underperformance, but stocks should also benefit.

It may seem odd that with stocks only down 6% from their January 2018 peak, they would already be pricing in such sub-par growth.[6] The main reason for this is that real bond yields, the discount rate for companies' cash flow, have collapsed by about 100 basis points in the past 10 months, increasing the value of stocks. Clearly, growth expectations have also fallen during that time, but by less than the discount rate. So as stocks went from 17.7x in January 2018 to 16.7x by 9 August 2019, real bond yields have fallen from 0.59% to 0.0% while our near-term growth expectations have moderated from 3.0% to 2.3%. Therefore, net-net, stocks have priced in the coming slowdown and actually have modest upside if our growth forecasts are correct (or some cushion, in a worse-than-expected economic outcome). It is important to note that this analysis is purely based on tactical indicators of value, as our more structural measures of value, which are more predictive for long-term returns (five years plus), still show global stocks, particularly U.S. stocks, to be expensively priced.

Market pricing and investment opportunities: Gold

Gold appears to be an attractive overweight opportunity in an environment where global real rates are going back into negative territory. In the near term, with TIPS (Treasury inflation-protected securities) yields already at 0.0%, there is likely not much

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[3] MSIM Global Multi-Asset Team estimates. The indirect tariff impacts are the effects that the import tax hit (for the U.S.) or export tax hit (for China) has on consumption and investment as well as the resulting risk aversion and weaker financial conditions. The latter are clearly much harder to estimate and do bake in a certain amount of reflexivity between the tariffs' economic impacts on growth and markets' response to that, and therefore may exaggerate the actual hit to the economy.
[4] MSIM Global Multi-Asset Team Analysis; IBES; Haver Analytics; Bloomberg L.P.; Based on today's 15.0x forward EPS multiple for the MSCI All-Country World Index
[5] MSIM Global Multi-Asset Team estimates; Bloomberg L.P.; Haver Analytics; assumes U.S. 10-year Treasury yields at 1.7% with GDP growth at 2.3% and yields at 2.0% with GDP growth at 2.5%.
[6] MSIM Global Multi-Asset Team Analysis; Bloomberg L.P.; MSCI AC World Index Net USD, as of 5 August 2019.

more near-term upside to gold unless additional risks to global growth materialize or the Fed makes more explicit that its reaction function has shifted to a bias toward more cuts even if global growth stabilizes at 2.5%. But it is clear that central banks globally have turned extremely dovish and that the shift to lowering rates based mostly on low inflation, rather than low growth, favors gold on a structural basis.

Market pricing and investment opportunities: U.S. Value vs. Growth, Momentum, Low Volatility

As we have mentioned previously, Value stocks have become extremely cheap, whether compared to Growth stocks, Momentum stocks, or Low Volatility stocks, presenting a potentially interesting opportunity. On an industry-neutral basis, Value stocks are trading at a forward price-to-earnings multiple of 8.7x. That is nearly -50% below our measure of fair value relative to growth stocks and -32% below fair value to Momentum and Low Volatility stocks, matching extremes reached only twice in the past 30-years (2000 and 2008).[7]

The underperformance of value has been driven by slowing growth impacting earnings expectations, and falling interest rates impacting valuations, as the market has sought out and bid up securities that can generate above-average growth and historically more stable returns. Today, consensus expectations for earnings growth rates are similarly at an extreme, with the EPS of Growth stocks expected to outgrow those of Value by 9.0% over the next three to five years, the highest gap ever and almost double what is typically expected.

And for the past few years, Value's relative performance has been highly correlated with rates and even more so with the yield curve, which today at -30 basis points on the 10-year vs. 3-month Treasury curve is flashing recession warnings. Relative valuations of Value to Growth stocks today reflect the same pessimism, as they are discounted to levels historically associated with global economic growth rates that are below even our worst-case tariff escalation scenario.

Market pricing and investment opportunities: Cyclicals vs. Defensives

Cyclicals remain expensively priced relative to defensives, and have not priced in the deceleration to 2.3% global growth that we project based on the latest round of tariffs, let alone the further escalation of tariffs that the U.S. has threatened. Cyclical stocks are 15% above our measure of fair value relative to defensives (trading at an 18% premium to defensives, vs. a 2% historical average premium). Meanwhile, fundamentals have been deteriorating: relative forward earnings per share for U.S. cyclical vs. defensives are down 4.8% year-over-year. Earnings growth differentials have historically correlated with global GDP growth, as has been the case for the last 18 months. Based on our forecast for global growth to continue slowing, cyclical earnings should continue to underperform defensives, with potential for greater underperformance in the event that the trade war deteriorates.

We note that a major driver of cyclical outperformance has been tech stocks, which are up +28% year-to-date, vs. 18% for the rest of the market.[8] The strong performance of tech stocks has also been a driver of Growth and Momentum outperformance vs. Value stocks as well. A major question is whether weaker global growth, greater regulatory scrutiny, tariffs on tech-heavy trade with China and the overall balkanization of technological development which appears to be taking place as China and the U.S. compete for dominance in economic, technological, and geopolitical areas has the potential to destabilize technology's predominance in markets. At that point, Value vs. Growth, defensives vs. cyclicals, and rest-of-world vs. U.S. equities are all potentially extremely interesting investment opportunities.

Summary and current positioning

In our portfolios today, we hold a neutral position in equities and bonds. We recently established overweight positions in Value and are underweight Momentum and Quality and are looking to add to these positions. We are neutral on the U.S vs. global stocks, except in the case of eurozone domestics, where we are overweight vs. U.S. equities. We maintain a small underweight position in the dollar, and are bullish gold but have been reducing positioning, given overbought near-term sentiment.

We are watching for signs that tech stocks have begun to underperform, which would signal a potentially very attractive opportunity to be underweight U.S. vs. rest of world, Growth vs. Value, and cyclicals vs. defensives.

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

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7 MSIM Global Multi-Asset Team Analysis; Bloomberg L.P.; Haver Analytics; Fair value measured as historical average relative valuation from 1975 to 2019.
8 MSIM Global Multi-Asset Team Analysis; Bloomberg L.P.; S&P 500 Information Technology sector, prior to the 28 September 2018 GICS reclassification that impacted the consumer discretionary, IT, and telecommunications services sectors; as of 9 August 2019.

FUND FACTS

Launch date	Base currency	Index	Morningstar Category
01 October 2015	Euro	Custom Blended Index	EAA Fund EUR Moderate Allocation - Global

Performance (%)

As of date 31 July 2019 (Class Z Share at NAV)

	MTD	YTD	1 YR	3 YR	5 YR	SINCE INCEPTION
Global Multi-Asset Income Fund - Z Shares	2.09	11.62	9.53	3.95	--	4.67
Custom Blended Index	2.18	13.19	10.68	4.82	--	6.66
Morningstar Category Average	1.23	9.34	1.69	2.86	--	--

12 Month Performance Periods to Latest Month End (%)

	JULY '18 - JULY '19	JULY '17 - JULY '18	JULY '16 - JULY '17	JULY '15 - JULY '16	JULY '14 - JULY '15
MS INVF Global Multi-Asset Income Fund - Z Shares	9.53	2.80	-0.23	--	--
Custom Blended Index	10.68	3.95	0.11	--	--

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.**

From 22 June 2016 the Custom Blended Index is comprised of 50% Bloomberg Barclays Global Aggregate Index (EUR), 30% MSCI All Country World Index (EUR), 5% Dow Jones Brookfield Global Infrastructure Index (EUR), 5% FTSE Nareit Developed Index (EUR), 5% Bloomberg Barclays Global High Yield Index (EUR), and 5% JP Morgan EMBI Global Index (hedged EUR). Prior to 22 June 2016 the Custom Blended Index was comprised of 50% Bloomberg Barclays Global Aggregate Index (USD), 30% MSCI All Country World Index (USD), 5% Dow Jones Brookfield Global Infrastructure Index (USD), 5% FTSE Nareit Developed Index (USD), 5% Bloomberg Barclays Global High Yield Index (USD), and 5% JP Morgan EMBI Global Index (USD). Benchmark performance shown is a blended combination of Custom Blended Indices above. The Benchmark is rebalanced monthly.

Asset Allocation (% of NAV)

	FUND	ACTIVE WT
Global Equities	29.43	-0.57
Global Fixed Income	51.82	1.82
Global High Yielding Investments	20.48	0.48
Volatility	-0.43	-0.43
Cash	-1.31	-1.31

Regional Currency Exposure (% of NAV)

	FUND
Developed Markets	**92.86**
North America	49.16
Europe	28.39
Asia ex-Japan	4.55
Japan	10.76
Emerging Markets	**7.14**

Regional Allocation (% Net of Cash)

	EQUITIES	FIXED INCOME
North America	13.53	23.24
Europe	11.67	8.57
Asia ex-Japan	-1.20	9.87
Japan	2.44	7.04
Emerging Markets	2.97	3.11

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 a range of assets with different levels of risk 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.
- Commodity investments can change significantly and quickly in value as a large variety of factors affect them.
- There are increased risks of investing in emerging markets as political, legal and operational systems may be less developed than in developed markets.
- The derivative strategy aims to increase the income paid to investors, but there is potential for the fund to suffer losses.
- 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 July 2019 and subject to change daily.

INDEX INFORMATION

Bloomberg Barclays Global Aggregate Index (EUR) provides a broad-based measure of the global investment grade fixed-rate debt markets. Total Returns shown in unhedged USD.

The MSCI All Country World Index (ACWI) is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of developed and emerging markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

Dow Jones Brookfield Global Infrastructure Index (ACWI) is a float-adjusted market capitalization weighted index that measures the stock performance of companies that exhibit strong infrastructure characteristics. The Index intends to measure all sectors of the infrastructure market.

FTSE EPRA Nareit Developed Index is a free float-adjusted market capitalization weighted index designed to reflect the stock performance of companies engaged in specific aspects of the major real estate markets/regions of the developed world..

Barclays Global High Yield Index provides a broad-based measure of the global high-yield fixed income markets. It is comprised of the Barclays U.S. High Yield,Pan-European High Yield, U.S. Emerging Markets High Yield and Pan-European Emerging Markets High Yield indices.

JPMorgan EMBI Global Index tracks total returns for U.S. dollar-denominated debt instruments issued by emerging markets sovereign and quasi-sovereign entities: Brady Bonds, loans, Eurobonds and local market instruments for over 30 emerging market countries.

The **Standard & Poor's 500® Index (S&P 500®)** measures the performance of the large cap segment of the U.S. equities market, covering approximately 80% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

The **MSCI Emerging Markets Index** (MSCI EM) is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

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