Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Global Multi-Asset Opportunities Fund

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

Performance Review

In the one month period ending 31 March 2019, the Fund's Z shares returned -0.64% (net of fees)[1].

During the month, the MSCI All Country World Index (ACWI) returned +1.6% in local currency terms (+2.7% EUR) and the JP Morgan Global Government Bond Index returned +1.8% in local currency (+2.8% EUR).[2] Commodities returned +1.6% in USD and +3.0% in EUR (S&P GSCI Index).

Contributors to performance included positions around our expectation for a slowdown in Australia (e.g. short Australian vs. developed market banks and long 3-year Australian government bonds). Long positions in China A-shares and in U.S. midstream energy stocks vs. U.S. equities also contributed. Detractors from performance included long positions in emerging market currencies including in the Argentine peso, the Hungarian forint, and the Turkish lira. A long in eurozone banks vs. eurozone stocks also detracted.

Market Review

Global equities rose +1.6% in March, ending the strongest quarter since 2009 up +12.3%, as markets appeared to be discounting supportive central banks amid muted inflation and slowing but stable growth—an eventual soft landing for the economy. In economic data, global flash PMIs for March disappointed, as did a particularly weak February U.S. jobs report (nonfarm payrolls came in at 20k vs. 180k expected and 312k prior). Despite fundamental headwinds, several clouds hanging over markets began to part during March, helping risky assets rally: the EU granted an extension on Article 50 (meaning Britain did not crash out of the EU without a deal on March 29), and China and the U.S. appeared to be making progress on a trade deal.

Within regions, the U.S. (+1.9%) and eurozone (+1.8%) led, while emerging markets (+0.8%) lagged, in part on strength in the U.S. dollar, which rose +1.2%.[3] Emerging market bonds and currencies also fell -1.7% each (JP Morgan Emerging Markets Currency Index and JPM GBI-EM Index in USD).

In fixed income, global government bond yields collapsed, reflecting the dovish turn of global central banks, with the U.S. 10-year Treasury falling 31 basis points to 2.41%, the lowest level in over a year. German 10-year bund yields fell by 25 basis points into negative territory (-0.07%) for the first time since 2016. A number of U.S. yield curves slightly inverted in March, triggering concerns that this inversion is signaling a recession. Typically prior to a recession you would see the yield curve (we look at 3-month to 10-year) to go more deeply negative, and for a more prolonged amount of time, 6 to 18 months before a recession.

Commodities rose 1.6% in March, driven by higher oil prices (S&P GSCI Index in USD). Brent crude rose +3.6%, as OPEC+ agreed to keep supply cuts in place until June. Gold fell -1.6%.

The U.S. dollar strengthened by 1.6% (DXY Index), with high-beta emerging market currencies the largest underperformers: the Argentine peso fell -10%, and the Brazilian real and Turkish lira each fell -4%.

Portfolio Activity

We believe that housing bubbles in Australia and Canada are beginning to deflate, and increased our short position in Australian banks. We also initiated a long in Australian 3-year rates and a short in Canadian banks vs. global equities.

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1 Source: Morgan Stanley Investment Management Limited. Data as of 31 March 2019.
2 Currency abbreviations used in this report are: EUR = euro, USD = U.S. dollar, RMB = renminbi
3 MSCI ACWI in local currency terms; S&P 500 Index in U.S. dollar terms; EURO STOXX 50 in EUR terms; MSCI EM Index in U.S. dollar terms.

We initiated a long directional position in China A-Shares, as Chinese liquidity and policy messages appear supportive of an equity re-rating, valuations are relatively cheap vs. history and retail-driven participation appears muted vs. prior episodes of liquidity fuelled re-ratings.

We continue to believe that eurozone growth will rebound over the next 6 to 12 months and initiated a long in eurozone autos vs. global equities, while increasing longs in eurozone domestic stocks vs. U.S. equities and in eurozone banks vs. eurozone equities.

We increased a long in the Hungarian forint vs. the euro, as well as a directional long in gold, and reduced our long in U.S. housing vs. U.S. equities, as well as a long in the Turkish lira.

We closed longs in the British pound vs. the U.S dollar, and in U.S. 10-year TIPS (Treasury inflation-protected securities), booking profits in each, and were stopped out of shorts in the U.S. dollar (via DXY Index) and in the Chinese renminbi vs. G10 currencies ex-USD.

Strategy and Outlook

Pro-Cyclical Rally to Continue

Despite the strong recovery in many risky assets since Christmas 2018, the market's mood remains sober. Even as global equities have risen almost 17% over this period, the majority of investors have continued to be skeptical of the rally and lightly positioned. Global equity funds have seen $87 billion in outflows year-to-date, and investor survey data in March showed that fund manager positioning in global equities is at levels last seen in the prior mid-cycle slowdown of 2016.

The dovish policy turn, most notably by the Federal Reserve (the Fed) but also the European Central Bank (ECB), was a major force that lifted risky assets and led to a pronounced global rates rally. Yet both the central banks' dovishness and the lower rates themselves appear to have exacerbated growth concerns. The inversion of the U.S. yield curve (albeit brief and partial) and the lowering of official growth and inflation forecasts by the Fed and the ECB seemed to support the perceived inevitability of a continued slowdown. Intriguingly, many areas of the market still appear to be pricing in a severe slowdown or recession (e.g. U.S. banks, short-end bonds, many cyclical stocks, and certain areas of the eurozone and Japanese equity market).

Global growth data have been mixed during the first quarter of this year, but appear to have begun to show reacceleration. We see accumulating evidence of resilience in what have been, until recently, perceived as the global economy's weak links. China's stimulus efforts have become more pronounced, and as supportive measures and policies have been introduced, credit growth has begun to accelerate. And eurozone growth appears poised to stabilize in response to fiscal support and the reversal of one-off headwinds. We expect that a cyclical upturn and the perception of the global economy being in better structural shape than feared will likely drive outperformance of certain growth-sensitive assets. While the delayed effects of Fed tightening during the past two years and elevated fragility of China's credit system make this cyclical upswing potentially limited and tenuous, we believe that the probability of a soft landing rather than a recession in 2020 is now 60% (up from 40% previously). As a result, we have added positions that stand to benefit from improving global growth but are still priced for a more bearish outcome.

The Fed's dovish pivot over the past six months has been a major change in global policy and is likely to be appreciably supportive of growth conditions in the U.S. and globally. The Fed's overly hawkish stance in the third quarter of 2018 that scared the markets has been largely walked back. In addition to pausing rate hikes, the Federal Open Market Committee (FOMC) has reduced its long-run neutral policy rate back to 2.8%—from 3% at the peak of optimism in the third quarter—and indicated it would hike rates only once in 2020, down from the committee's expectation in November of last year of three hikes in 2019 and one in 2020. The market has gone even further and is now pricing in 21 basis points of rate cuts by the end of 2019 (down from three hikes as of November 2018). Further, the Fed has begun to reassess its framework, considering the possibility of adopting an average inflation target, rather than an upper limit. While it is not clear what the specific policy implications of this change would be, the probability that the Fed will allow inflation to accelerate above 2% while refraining from rate hikes has risen. In other words, monetary policy will likely remain stimulative for longer. With the latest inflation data below 2% and missing expectations (core Personal Consumption Expenditures decelerated to a 1.8% annual pace in January 2019 from 2.0% prior and vs. the consensus expectation of 1.9%), the Fed appears to have additional room to remain dovish.

A lower 'discount rate' is generally supportive for risky assets. The 10-year Treasury yield rallied below 2.4% in March, briefly falling below the fed funds rate. Lower rates have clearly lifted many risky assets already—particularly rate-sensitive assets such as U.S. REITs and gold—yet their full effect remains to be fully felt. For example, even after the recent equity rally, the U.S. equity risk premium of 3.9% is excessive and is consistent with 2.6% global GDP growth for the remainder of this year. If global growth accelerates to 3%, in line with our forecast, this would suggest a 3.6% equity risk premium, or an 11% upside potential for stocks (assuming static bond yields).

The ‘discount rate’ argument aside, cheaper financing is supportive for growth. Housing activity in the U.S.—the more rate-sensitive segment of the economy and the classic ‘transmission mechanism’ of monetary policy—appears to be rebounding after having decelerated in the second half of 2018. With the 30-year fixed mortgage rate having fallen ~80 basis points, from 4.8% to 4.0%, new home sales have spiked back to 5.6 million units (new and existing combined) in February from a low of 5.0 million in January, reversing the entire decline of last year. While the latest data point may overstate the rebound due to the volatility of the data, housing transactions appear to have bottomed even on a smoothed, three-month moving average basis. Likewise, recent rebounds in the U.S. Mortgage Bankers Association (MBA) Purchase Index and the National Association of Home Builders (NAHB) Index also indicate that housing market activity has turned up. The housing recovery has been prolonged but relatively shallow, such that activity levels are at approximately mid-cycle conditions. With household formation having recovered from under 650,000 new households per year in the first several years of this cycle to 1.5 million new households in 2018—the highest level in the last 30 years outside of 2005—it appears that structural, pent-up demand is there to support additional expansion of the housing sector, especially the more economically impactful single-family housing sector. With close to a third of 18- to 34-year-olds still living at home, there is potential for demand growth from these 3 million-plus additional house buyers. Interestingly, the homeownership rate among people under 35 has begun to grow over the past three years but at 36% remains well below its peak of 44% fifteen years ago.

The Fed’s dovish turn also serves to alleviate corporate leverage risk, at least in the near term. Elevated leverage in the U.S. high yield corporate sector, at 4.2x EBITDA,[4] has been widely identified as an area of potential risk. While the corporate high yield sector’s interest coverage ratio remains fairly high, at 3.8x, meaningfully higher rates would, in theory, weaken interest coverage. U.S. corporate health remains extremely strong, with 2018 EBITDA margins of over 15% for high yield and nearly 30% for investment grade, and strong cash flow generation. Although this likely dampens additional earnings and cash flow upside over the medium term, the corporate sector is unlikely to be the economy’s Achilles heel, especially if rates stay low and credit quality remains high.

From a structural point of view, we are open to the possibility of positive supply-side developments that would extend the cycle. Recent deregulation measures notwithstanding, we note that it is rare for productivity growth to recover in later stages of the cycle (the late 1990s is an exception). However, it appears that the labour force has room to maintain a high growth rate (currently close to 1.25% on a three-month smoothed basis). This is because the labour force participation rate of the core 25-to-54-year-old segment of the population is 82.5%, with room to continue to recover to the pre-crisis level of over 83%, and perhaps to catch up to the advanced economy average of over 85%.

While we still expect a continued slowdown of the U.S. economy from the strong 3.5% GDP growth pace during the middle of 2018, we currently think growth can stabilize closer to (but likely below) a 2% pace by the end of this year, above the 1.5% pace we envisioned six months ago.

China’s more aggressive stimulus efforts over the past several months have been another consequential shift in the global policy setting. Although Chinese authorities began to loosen policy during the second half of 2018, these measures were insufficient, constrained by concerns about adding further leverage and, perhaps most importantly, by the need to prevent a disorderly devaluation of the renminbi, which was depreciating (and fell by 8% vs. the U.S. dollar) during that period. But with GDP growth having slowed to below 6% in the fourth quarter of 2018 and a hawkish Fed less of a threat to the currency, the authorities have begun to open the taps. New credit surged by Rmb 4.9 trillion in January and February combined, or 5.4% of 2018 GDP. Liquidity conditions improved as cuts in China’s Reserve Requirement Ratio since mid-2018 have released an additional Rmb 4.9 trillion (or 5.4 % of GDP). Taxes are slated to be cut by 2% of GDP (though we expect their net impact to growth to be under 0.5%) and various administrative easing measures with respect to housing and local government financing have been announced. Anti-private business rhetoric has been walked back, and supportive statements and specific measures for small and medium-size business have likely helped business sentiment. As a result of these measures and announcements, we have seen improvement in both survey and hard activity data. Car sales, luxury-related consumption measures (e.g., watch sales), and housing activity appear to have bottomed over the past several months. Retail sales growth has rebounded in year-over-year terms. China’s industrial production growth reaccelerated sequentially over the past five months and manufacturing PMIs (both NBS and Caixin) have turned up.

The apparent upturn in China’s growth—and specifically in its industrial indicators—has profound implications not only for China, but also for the global industrial cycle. China’s industrial activity has tended to lead global swings in the industrial cycle by one to three months since 2009 (with the exception of the European recession in 2012). In the current environment, this signal is particularly significant because it helps tip the scales in the debate over the recent divergence between 1) the consumer and services sides of the global economy, which have remained largely resilient, and 2) the production and business side (as measured by industrial activity and capex), which have been weak. For example, global retail sales growth remained at a

[4] EBITDA = earnings before interest, taxes, depreciation and amortization

3.4% pace in the first two months of this year, as compared to 3.5% during 2018. And the deceleration indicated by the fall in services PMI has been substantially less pronounced than the collapse in global manufacturing PMI, which, in our assessment, fell to levels consistent with 2.6% global GDP growth in the first quarter of this year.

During the height of U.S./China trade-related tensions, we expected that tariffs would reduce global growth by 14 basis points over two years.[5] Our expectation was based on the best available estimates at the time; however, because the scale of these measures would have been unprecedented, our confidence in these assessments has been low. It is likely that markets priced in a much more dire economic outcome for a trade conflict. While the worst-case scenario appears to have been averted for now, trade fluctuations did prompt growth concerns in the fourth quarter of 2018. Global exports fell nearly 3% sequentially (annualized) and were the weakest they have been during this expansion, except for the second quarter of 2015 during a significantly more pronounced global slowdown. Although the trade data were worrisome for the markets, we believe they overstated the underlying economic weakness. First, the weak fourth quarter came after strong 4.5% sequential annualized growth in the prior quarter. Second, trade weakness was substantially lower than other, generally closely related indicators such as industrial production would have suggested. And third, the trade slowdown was disproportionately more pronounced for China and the U.S. (which together accounted for almost half of the drop in exports) while representing about a quarter of global trade. Although the slowdown in China in the second half of last year likely played a role, it appears that the weakness was exacerbated by dispute-related shifts in the trade patterns during 2018.

The eurozone's growth weakened significantly in the second half of last year, and we believe it is poised to improve imminently. Eurozone GDP growth fell to 0.7% (annualized) in the second half of 2018, and industrial production collapsed by nearly 5% (annualized) in the second half. Exports growth also slowed sharply from 6.4% year-over-year in the fourth quarter of 2017 to a 1.5% pace in the fourth quarter of 2018. However, as global growth rebounds, led by China, Europe's trade should also recover (albeit with the typical delay of approximately three months). In addition, several idiosyncratic factors detracted approximately 30 basis points from the eurozone's growth in the second half of last year, which we expect to reverse this year. These include the emissions-related slowdown in car production and the disruption of transport traffic on the Rhine River, which we estimate reduced eurozone growth by 5 and 7 basis points, respectively, in the second half of 2018.

We now place a greater probability in a scenario where global growth remains resilient over the next two years, i.e. that it will slow, but remain above potential. Over the next two quarters it has the potential to accelerate from 2.3% in the first quarter of this year to 3.0% in the third quarter.[6] If global growth accelerates, growth-sensitive assets whose performance lagged this year will likely outperform. Some of dovish policy plays—such as government bonds and rate-sensitive assets—may underperform as the monetary policy outlook is reassessed to be less dovish, especially in the U.S. We expect bond yields to rise, with the 10-year yield reaching 2.7%. Although higher rates may be an emerging headwind to stocks, we still expect stocks to outperform bonds over the next six months. A steeper yield curve and improving growth are likely to be supportive of many 'value' assets, and we prefer U.S. financials and European equities such as banks, domestically-oriented stocks, German equities and auto manufacturing stocks. Many China-related assets such as A-shares and global metals and mining stocks also remain undervalued, and we expect them to outperform as growth and liquidity in China improve.

There remain substantial risks to the near-term growth acceleration scenario as well as a soft landing in 2020. First, although the Fed may have paused its hiking cycle just in time to avert a disaster, the come-down from the U.S. fiscal stimulus 'sugar high' is still likely to cause the U.S. economy to slow. We estimate that the fiscal impulse will detract -60 basis points from U.S. GDP growth in 2019 as compared to 2018, although the exact timing and magnitude of its impact are uncertain. Second, after three substantial credit-acceleration cycles, fragilities in China's financial system are a major concern. The ability of the Chinese economy to lever up for the fourth time since 2008 sufficiently to meaningfully affect growth may be limited. Lastly, while many one-off headwinds that depressed growth in the eurozone last year are likely to wear off shortly, the persistently slow growth, below-target inflation and negative policy rate represent signs of malaise that are potentially becoming entrenched. With this in mind, our embrace of the near-term cyclical rebound is only partial and the cyclicality of our portfolios is modest. We watch for the above-mentioned risks to reassert themselves in the near future.

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

FUND FACTS

Launch date	Base currency
22 April 2014	Euro

5 Assumed existing tariffs remained in place, with 80% probability that 10% tariffs on $200 billion in Chinese goods would rise to 25% (with partial retaliation from China), 50% probability that the U.S. imposed 25% tariffs on the remaining $267 billion in Chinese goods (with partial retaliation from China), and 10% probability that the U.S. imposed 25% tariffs on non-USMCA autos and parts imports (with full dollar-for-dollar reciprocation).

6 Note that the 1Q19 was particularly weak due to the U.S., where a government shutdown helped slow the pace of growth to 1.0%, and that the 2Q19 bounce-back may be exaggerated as a result. Excluding the impact of the first-quarter government shutdown in the U.S., global growth is accelerating from a 2.6% pace during 4Q18-1Q19 to 3.0% in 3Q19.

12 Month Performance Periods to Latest Month End (%)

	MARCH '18 - MARCH '19	MARCH '17 - MARCH '18	MARCH '16 - MARCH '17	MARCH '15 - MARCH '16	MARCH '14 - MARCH '15
MS INVF Global Multi-Asset Opportunities Fund - Z Shares	-3.96	-0.22	-2.64	-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**

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 a range of assets with different levels of risk and the fund's simulated and/or realised return has experienced high 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.
- 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 March 2019 and subject to change daily.

INDEX INFORMATION

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.

The **S&P GSCI Commodity Index** is a composite index of commodity sector returns, representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities.

The **US Dollar Index (DXY)** is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of US trade partners' currencies.

The **JPMorgan Global Government Bond Index** is a market value weighted fixed income index comprised of government bonds in developed countries.

The **Euro Stoxx 50 Volatility Index (VSTOXX)**, which is the "European VIX" measures implied volatility of near term options on the EuroStoxx 50 index (Eurozone blue chip stock index with very liquid futures and options). Like the VIX, the VSTOXX is calculated from two expiration months, interpolated to get constant 30-day maturity.

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.

The **JP Morgan Emerging Market Currency Index (EMCI)** is a fixed weight tradable version of the Emerging Local Market Index (ELMI+ index), tracking 10 liquid currencies across Latin America, Asia and Central & Eastern Europe, Middle East, Africa (CEEMEA) vs. USD. The ELMI+ tracks total returns for local-currency denominated money market instruments in 23 emerging market countries. The ELMI+ employs a liquidity-sensitive weighting system, which uses exports plus imports as a base.

The **JPMorgan Government Bond Index-Emerging Markets (JPM GBI-EM)** is a definitive local emerging markets debt benchmark that tracks local currency government bonds issued by emerging markets. It is the first comprehensive, global local emerging markets index. The GBI-EMGD limits the weights of those index countries with larger debt stocks and redistributes those weights to the countries with smaller weights. The maximum weight to a country is capped at 10%. The excess is redistributed to those countries that have a market capitalization of less than 10%. The portion that is redistributed is based on the market capitalization of each country, which preserves the relative size of each market within the index.

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.

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