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INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Sustainable Asia Equity Fund

MARKETING COMMUNICATION | EMERGING MARKETS EQUITY TEAM | QUARTERLY COMMENTARY | 31 MARCH 2022

Performance Review

In the three month period ending 31 March 2022, the Fund's I shares returned -10.04% (net of fees)[1], while the benchmark returned -7.99%.

All three months of the first quarter recorded negative returns on worries over rising inflationary pressures, war in Ukraine and the slowdown in China. Asian markets were clearly bifurcated with ASEAN markets (Indonesia, Thailand, the Philippines and Malaysia) all recording positive returns in U.S. dollar terms while North Asia markets (China, Korea, Taiwan) were the worst performers with China down more than 14% for the quarter.

The Sustainable Asian Equity Fund returned -10.04% (I shares net of fees) compared to a -7.99% return for the benchmark during the quarter, bringing the trailing 12-month return to -8.93% vs. -14.64% for the benchmark.

Our underweight allocation to China along with overweight allocations to Indonesia, India and Taiwan contributed, while our stock selections in Taiwan, Hong Kong and Singapore along with the overweight allocation to non-Asian markets detracted. At the stock level, our overweight selections to Bank Rakyat, Bank Mandiri, Hindalco Industries and Bank Central Asia contributed, as the Indonesian banks benefited from the strong domestic and rate environment and Hindalco benefited from rising metals prices, while our overweight selections to SEA Ltd, Silergy, ASML Holding and Shenzhou International detracted. We have exited SEA on continued regulatory and market headwinds.

Market Review

China equities finished the quarter on a wild month in March with the MSCI China Index dropping to a near-five year low early in the month amid escalating geopolitical tensions, renewed ADR (American depository receipt) delisting concerns and China's worst COVID-19 resurgence, followed by a strong rebound in the latter half of the month as the authorities ramped up policy support to stabilize the market and the economy. China, as noted earlier, was the worst performer during the quarter. China's market also saw a record amount of share buybacks announced in the month of March after the broad-based sell-offs in the quarter, which depressed valuations. This was the third straight quarter of negative returns for China.

In the annual National People's Congress, China set an ambitious gross domestic product (GDP) growth target of "around 5.5%" for this year despite the mounting growth pressure. The policy tone was unambiguously pro-growth, as the policymaker called for more proactive monetary and fiscal policies. The fiscal deficit-to-GDP ratio target was set at 2.8%, down from last year's 3.2%, but after adjusting for a transfer from the fiscal stabilization fund and other funds, the actual fiscal spending should be stronger than last year. Meanwhile, Premier Li Keqiang again reiterated that "housing is for living, not for speculation", suggesting there is no plan for a large-scale stimulus for the property sector.

While the policy stance has turned supportive, China still faces tremendous challenges to achieve this year's growth target. The current wave of COVID-19 resurgence in China, which is the worst since the initial outbreak in 2020, only puts further downward pressure on the already subdued growth outlook. The highly transmissible omicron variant has led to a dramatic jump in infections and spread to more than a dozen provinces going into March, triggering de facto lockdowns in major cities including Shanghai and Shenzhen. As China continued to stick to the "dynamic zero-COVID" strategy, the stringent virus control measures have caused substantial economic disruptions in some of the main economic regions in the country, damaging near-term growth momentum.

Indeed, China's NBS (National Bureau of Statistics) manufacturing purchasing manager index (PMI) declined to 49.5 in March from 50.2 in February and the non-manufacturing PMI dropped to a six-month low of 48.4 in March from 51.6 in February. Meanwhile, the deep contraction in the property sector extended into March. According to data from China Real Estate Information Corporation (CRIC), the top 100 property developers reported year-on-year sales volume growth of -56.5% in March, down further from -43.4% in January-February.

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 March 2022.

Dozens of listed companies in Hong Kong have postponed releasing annual results past the 31 March deadline due to the COVID-19 outbreak or auditor changes, potentially triggering waves of trading halts. In particular, the list includes several debt-wracked Chinese property developers, another sign of the financial stress they are grappling with. Several auditors have resigned from a series of Chinese property companies, due to the challenges of verifying these businesses' financial health after the severe real estate sector downturn.

In response to the sharp market correction in the first two weeks of March, Vice Premier Liu He chaired a Financial Stability and Development Committee meeting in an effort to stabilize the market and boost confidence. Vice Premier Liu vowed more coordinated and market-friendly policies and called for a quick wrap-up of the regulatory campaign. Liu also noted that China is making good progress on ADR audit talks with U.S. regulators and vowed to further support overseas listings of Chinese firms. The equity market bounced forcefully after the announcement.

Moreover, the People's Bank of China (PBOC) reiterated "active" monetary policy at its first quarter monetary policy committee meeting. The meeting statement also added that the central bank would work on "improving the monetary policy transmission mechanism" and "increase relending to the agriculture sector and small and medium-sized enterprises (SMEs)". Premier Li Keqiang, meanwhile, also held a State Council meeting and stated that policymakers would stick with the full-year economic targets, prioritize growth stability and expand investment through better utilization of government bonds.

Externally, the U.S. Securities and Exchange Commission issued a provisional list of Chinese stocks subject to forced delisting under the Holding Foreign Companies Accountable Act (HFCAA), which it says the Public Company Accounting Oversight Board (PCAOB) was unable to inspect their audit paper. Companies are subject to delisting from U.S. exchanges if they fail to comply with auditing requirements for three consecutive years. The China Securities Regulatory Commission (CSRC) reiterated its earlier stance that China is willing to work with the U.S. on the auditing inspections but opposes politicizing securities regulation. The securities regulator reportedly has asked some U.S.-listed internet companies, including Alibaba, Baidu and JD.com, to prepare audit documents for the 2021 financial year keeping in mind U.S. regulators' requests for more disclosure.

On foreign trade, the Biden administration said it is realigning its trade policy toward China, looking at all existing tools and potentially new ones to combat Beijing's state-led non-market practices. In its annual trade policy agenda release, the Office of the U.S. Trade Representative said the U.S. is raising its concerns directly with China and accelerating joint work with allies and partners. Without offering specifics, U.S. trade negotiator Katherine Tai also said in an interview that Washington needed new, more effective tools to defend its economic interests and better compete with China. Separately, the U.S. renewed tariff waivers for 352 categories of goods from China after previous exemptions expired. The items that will be exempted include certain kinds of bicycle parts, electric motors, machinery, chemicals, seafood and duffel bags.

Hong Kong saw continued slowing economic momentum during the quarter given the COVID-19 lockdown. Retail sales fell sharply by 17.6% year-over-year on a 14.5% month-on-month seasonally adjusted contraction in February amid the most severe wave of COVID-19 resurgence thus far. The weakness was broad-based, led by a 40.8% month-on-month plunge in sales of clothing, footwear and allied products, followed by a 27.7% drop in jewelry and related valuable gifts. Although local confirmed virus cases have fallen from the peak of more than 60,000 to below 10,000 recently, local mobility remained subdued. As such, retail sales may have decelerated further in March. The government announced plans to ease social curbs from April as infections have started to subside, include lifting a ban on flights from nine countries, reducing quarantine for arrivals from abroad and reopening schools.

While Taiwan did better on a relative basis in March, it faced similar headwinds as the rest of North Asia. Financials and real estate outperformed on higher interest rates, while the technology segment was soft on global tech demand concerns. The central bank (CBC) raised its discount rate aggressively by 25 basis points to 1.375% in March. This followed the Federal Reserve's 25 basis point hike and marked Taiwan's first rate hike since 2011, bringing its policy rates back to pre-COVID levels. The rate hike was driven rising imported inflation pressures and a gradual recovery in domestic services sectors and labor market. While acknowledging potential shocks to Taiwan's growth amid the Ukraine crisis, the CBC kept its GDP growth forecast for 2022 almost unchanged at 4.05% (vs. 4.03% previously) while raising the consumer price index (CPI) inflation forecast notably to 2.37% from 1.59% previously.

The India market bounced in March, up +3.6%. It was the best performing country during the month, which helped its quarterly performance. While there were various negative factors, such as higher oil prices and rising inflationary pressures, domestic institutions have helped cushion some of the market weakness and the foreign selling. The Indian rupee remained essentially flat for the quarter, moving from 74.33 at December 2021 to 75.78 at the end of March 2022. February CPI increased to 6.1%, largely in line with expectations, while industrial production jumped even with the omicron-related slowdown. GDP growth of 7.3% in the fourth quarter of 2021 disappointed, bringing the full-year growth to 5.4%, as there was hope of a significant rebound from the reopening of the economy. The much-awaited election results were announced during the quarter, reaffirming the ruling Bharatiya Janata Party's (BJP) dominance in Uttar Pradesh, Uttarakhand, Manipur, Punjab and Goa. Foreigners remained net sellers for the sixth month in a row, which was largely offset by domestic institutional buying. We continue to monitor the inflationary pressure, given India's large dependence on imported oil as the price remains over US$100, along with further pressure from higher commodity and agricultural product prices.

While Korea outperformed the decline in the region in March, it still ended the quarter as the second worst performing country as some of the index heavyweights, such as Samsung Electronics, fell nearly -13% during the quarter on worries of slowing growth. The stronger returns of the banks especially, such as our holding in KB Holdings, wasn't enough to offset the overall weakness. The most significant news was the presidential election results, where the opposition conservative candidate edged out the current ruling party. Expectations are for more market-friendly policies surrounding real estate, internet and financial regulations. The March CPI rose 4.1% year-over-year as the Ukraine war pushed up energy and commodity prices. Inflation is expected to rise further above the Bank of Korea's first half 2022 forecast of 3.1% with increasing pressure on the monetary policy board to raise rates further. The new administration has pledged to support SMEs and venture businesses along with providing tax credit for more onshoring of production and help with lower income households. March saw a divergence in the region's economic performance due to the global rising commodity prices and geopolitical tensions.

ASEAN markets broadly including Singapore were the main drivers for the region. Indonesia in particular benefited from the rise in commodity prices and helped fuel the rally along with the rise in bank stocks. We believe many of the region's coal, metals and oil companies may continue to benefit from the current strong pricing environment. The Indonesian government has raised taxes on palm oil exports while removing import volume restrictions, which is expected to subsidize cooking oil, as the central bank kept the policy rate unchanged at 3.5%. The February CPI rose at 2.06%, slower than the 2.18% recorded in January. From a macro perspective, Indonesia is also enjoying positive momentum on its trade balance along with robust growth in bank deposits helped by both foreign flows and domestic liquidity.

The Thai government has also approved subsidies to tackle high energy costs for oil, gas and electricity, as inflation jumped 5.28% in February compared to 3.23% in January. The government will also help minimize the impact of higher costs due to the Ukraine-Russia war, approving subsidies from May to July of 2022. Malaysia and Indonesia both lifted all quarantine requirements for international arrivals, which is set to boost their tourism industries. The Philippines central bank left the policy rate unchanged at 2% as CPI remained flat at 3.0% in February. President Duterte also signed an executive order incorporating nuclear energy as part of the energy portfolio as it tries to diversify its energy dependence on coal. We are continuing to monitor the developments in ASEAN markets as the region overall remains net importers of energy and the higher commodities prices will likely have a negative impact to consumer sentiment. However, with the upcoming listing of GoTo, we expect interest in the region to remain elevated.

Portfolio Activity

We switched from TSMC (Taiwan Semiconductor Manufacturing Co) local shares to ADRs given the recent compression of the premium to near parity pricing versus a nearly 10% average on a historical basis, to provide some market liquidity diversity.

We initiated positions in State Bank of India (SBI) and BOC Hong Kong Holdings Limited (BOC HK) by adding to the basket of banks. Pertaining to SBI, we believe that Indian banks will likely see better credit growth from the next quarter onwards. The pick-up in real estate, commodity, chemical and textile prices/margins has helped address a large portion of the stressed assets of Indian banks such as SBI. Moreover, unlike in the last cycle (2003-20007) when falling rates were good for Indian banks, which used it to book gains on their bond portfolios, this time rising rates (within reasonable limits) would help re-price assets ahead of liabilities. Furthermore, as Hong Kong is entering a rate hike cycle, we believe BOC HK will likely benefit from net interest margin expansion.

We initiated a position in BYD, which remains in our view the leading neighborhood electric vehicle (NEV) company with strong independent technology in batteries and a long safety track record. Its competitiveness in auto power systems and full supply chain integration are likely to provide it with an edge unlike other China electric vehicle (EV) brands. BYD sold 600,000 NEVs in 2021 (including hybrid power, 18% of China's NEV market share), and is targeting 1.5 million in 2022 (30% market share). We also started to build a position in Hua Hong Semiconductor Ltd after the semiconductor market underperformed in China in 2021. We believe Hua Hong could see supporting demand from China domestic integrated circuit design companies to support its growth and mitigate part of the cyclical risk faced by other second tier foundries.

We also initiated a position in CTBC Financial in Taiwan, which we believe is a potential beneficiary of overseas reopening and domestic loan growth. With the re-shoring of investments in Taiwan, the government's incentive to invest locally, and a higher GDP forecast, we see scope for the loan growth of Taiwan banks to increase and we expect banks to benefit from this. CTBC has one of the highest foreign exchange loan portfolios among Taiwan banks, at 30%+ vs. 5%-20% for other banks. We expect the gradual reopening of the global economy may help its earnings growth outperform peers. CTBC has historically generated a consistent 11%-13% return on equity and has been the highest among Taiwan banks (Mega 8%, Fubon 10%-11%), and we continue to view CTBC as a high quality bank in Taiwan. We believe CTBC stands out among its peers given its anticipated overseas and domestic loan growth, as well as its reduction in non-performing loans. Also, its current 5% dividend yield is likely to serve as a support to the share price.

We reduced our holdings in HK Exchange as our original thesis was that it would be a China proxy stock in the portfolio, which was expected to benefit from new China listings in Hong Kong rather than the U.S. markets. While that trend will likely persist, the reality is that the pace of new listings has disappointed given the current muted market interest in China with the continued increased regulatory headwinds.

We initiated a position in Max Healthcare Institute, a chain of hospitals in India, due to structural tailwinds. The medical tourism opportunity is growing in India, and there has been a solid track record of judicious capital allocation to private sector hospitals. Additionally, government-led price intervention, for devices such as stents, are largely in place and we believe brownfield expansion opportunities will likely continue to drive sector growth for the next three to five years.

We exited Alibaba and Meituan due to regulatory headwinds. We were particularly concerned with the latest salvo on reducing merchant fees for Meituan. We also exited SEA Ltd. As China internet stocks correct, it feeds into the valuation metrics for ex-China internet stocks, particularly for those names that disappointed on results, creating a downward spiral. The Tencent shareholding of SEA remains an overhang, and the disappointing guidance on gaming revenues raises questions on the pipeline. We then exited Bank Jago as we believed the stock price was running ahead of fundamentals. In other words, the stock was up about 75% since we initiated a position in the bank last year. We also exited Kakao Corp., taking profit with the stock up more than 170% since the initiation, and we anticipate relatively stagnant performance for internet stocks in Korea due to the regulatory environment and slowing (albeit still quite strong top-line growth) growth momentum compared to 2019-2020.

Strategy and Outlook

The recent shutdown in China due to COVID-19 will likely delay the normalization of the supply chain in the region, which will likely lead to elevated pricing pressure along with the ongoing Ukraine-Russia conflict. Given the size of the economy, China will continue to have outsized impact to growth. While China's economy has shown signs of a slowdown in growth due to the weakening property sector and lingering COVID-19 outbreaks, we believe our thematic alignment of quality growth companies in the region should weather the storm better with the ability to gain market share in many instances. The ongoing shift to the pandemic is likely to foster digital trends on both the consumer and enterprise sides, favoring companies that embrace and enable the digital transformation.

We continue to focus on select recovery candidates in the financials sector with those institutions that are ability to generate sustainable growth, along with select materials names. We continue to be invested in secular growers across consumer, technology and specific industrials companies.

At the end of the month, we have overweight allocations to India, Taiwan, Indonesia and the U.S. and underweight allocations to China and Malaysia. At the sector level, we have overweight exposures to the information technology and financials sectors. We have underweight exposures to the consumer discretionary, real estate, communication services, health care, utilities, consumer staples, industrials and materials sectors.

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

FUND FACTS

Launch date	Base currency	Index
01 October 1991	U.S. dollars	Blended Benchmark

Calendar Year Returns (%)

Past performance is not a reliable indicator of future results.

	YTD	2021	2020	2019	2018	2017	2016	2015	2014	2013	2012
Class I Shares	-10.04	5.79	26.24	18.53	-18.25	37.05	1.74	-6.96	1.71	1.91	19.35
Blended Benchmark	-7.99	-4.72	25.02	18.17	-14.37	41.72	6.11	-9.51	3.16	3.76	22.02

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.**

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Share Class I 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 company shares 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 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.
- Sustainability factors can pose risks to investments, for example: impact asset values, increased operational costs.
- There may be an insufficient number of buyers or sellers which may affect the funds ability to buy or sell securities.
- Investments in China involves a risk of a total loss due to factors such as government action or inaction, market volatility and reliance on primary trading partners.
- Investment in China A-Shares via Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect programs may also entail additional risks, such as risks linked to the ownership of shares.
- 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 2022 and subject to change daily.

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The **MSCI AC Far East ex Japan Index:** captures large and mid cap representation across 2 Developed Markets countries (excluding Japan) and 7 Emerging Markets countries in the Far East*. With 553 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **MSCI AC Asia ex Japan Index:** captures large and mid cap representation across 2 of 3 Developed Markets (DM) countries* (excludingJapan) and 9 Emerging Markets (EM) countries* in Asia. With 637 constituents, the index covers approximately 85% of the free float adjusted market capitalization in each country.

The **MSCI China Index** captures large and mid-cap representation across China A-shares, B-shares, H-shares, Red-chips and P-chips. It reflects the Mainland China and Hong Kong opportunity set from an international investor's perspective.

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