Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

Sustainable Euro Corporate Bond Fund

GLOBAL FIXED INCOME TEAM | MONTHLY COMMENTARY | 31 OCTOBER 2020

Performance Review

As the Fund is less than a year old we are constrained from commenting on its performance.

Market Review

In October, markets were in a "wait and see mode" as the U.S. election quickly approached, while a pickup in coronavirus cases was seen across the globe. Several European countries reimposed strict lockdowns to combat the spike in cases. Government bond yields rose in the U.S., Australia, Canada and New Zealand and generally fell across Europe. The 10-year Treasury yield increased by 19 basis points (bps), which is the biggest increase seen since September 2018. Risk sentiment continued to decline, with the VIX spiking at the end of the month, while 10-year breakeven inflation rates widened.

In the U.S., by the end of the month, a deal was not struck between House Speaker Pelosi and Treasury Secretary Mnuchin on further stimulus measures. Further negotiations appear to be stalled until the outcome of the election becomes clear – with a "blue wave" result supporting more stimulus in the near term, i.e. in the first quarter of 2021. The minutes from the Federal Reserve's (Fed) September meeting were released early in the month, and reiterated its stance on keeping rates near zero until inflation averages at least 2% over time. Fed officials did note concern over fiscal aid and its potential impact if it were to decrease or be eliminated. They also noted that the economic recovery seen over the past few months was due to the government support.

In the eurozone, is it likely that the European Central Bank (ECB) will boost the Pandemic Emergency Purchase Programme at its next meeting in December to support the euro area economy, given the recent spike in cases across the region and subsequent lockdowns seen across various countries. ECB President Lagarde emphasized that stimulus can be deployed on an "anytime, anyplace, anywhere" basis if needed and conditions deteriorate.

The U.K. also saw a spike in coronavirus cases in October, and national lockdown measures were announced as a result. It is now not a question of "if" but "when" additional stimulus will be announced. Brexit trade talks resumed in October and were subsequently called off as the European Union disputed the U.K.'s internal market bill. Brexit talks are supposed to resume in mid-November, with markets hopeful that a deal will be struck.

At the end of the month, the Bank of Japan met and kept rates on hold. The central bank expects conditions to improve significantly in 2021, although it trimmed its forecasts for the remainder of 2020. Bank of Japan Governor Haruhiko Kuroda noted that the economic outlook remains "highly uncertain and there are big downside risks".

Spreads were tighter in the month. The key drivers were continued expectations of monetary and fiscal support for markets as evidenced by ECB commentary; expectations of a Biden victory in the U.S. elections, coupled with a possible "blue wave" if the Democrats also win Congress; positive third quarter corporate reporting relative to lowered expectations; and continued strong demand for investment grade (IG) credit (including ECB quantitative easing purchases) in a month when supply slowed.

The Bloomberg Barclays U.S. Corporate Index (the U.S. IG index) closed 10 bps tighter in October to end the month at 125 bps over government bonds. Financials (13 bps tighter) outperformed non-financials (9 bps tighter). Within non-financials, BBB-rated names outperformed higher-rated securities. In terms of excess returns versus government bonds, the U.S. IG index generated a positive excess return of 0.99%. European IG, as measured by the Bloomberg Barclays Euro-Aggregate Corporate Index, underperformed the U.S. market in October, closing 2 bps tighter at 115 bps. Financials closed 2 bps wider, underperforming non-financials (5 bps tighter). In terms of excess returns versus government bonds, the euro IG index generated a positive excess return of 0.29%.

Portfolio Activity

In October, we rotated credit holdings, taking advantage of the new issue calendar and the technical bid for certain names. The portfolio remains with a small overweight to credit.

Strategy and Outlook

Strategy:

The Fund is underweight industrials and overweight financials. In particular, it holds high-quality corporate hybrids and subordinated financials (a mixture of banks and insurance companies in the lower Tier 2 part of the capital structure of systematically important institutions). The Fund has an exposure to green bonds of 17.28% versus 4.56% in the index.

The Fund is underweight duration.

Outlook:

On the technical front, the lower supply in the month was in line with expectations where issuers have front-loaded ahead of the uncertainty of the U.S. election in November and the expected lower volumes in December ahead of year end. More broadly, capital markets are expected to remain open, allowing companies to access liquidity at low rates.

Looking forward, we see the remainder of the year as characterized by lower liquidity with market direction driven by the latest headline. Our base case reflects the consensus view that coronavirus is transitory and monetary policy is credit-risk friendly. Overall, we expect monetary and fiscal stimulus to remain in place well into 2021, likely driving spreads tighter in the medium term. In the short term, we continue to see risks of volatility, but believe any downside is limited by expectations a vaccine will be developed in the next six months. Political risk is also expected to reduce in the first quarter of 2021 following the U.S. elections and Brexit negotiations, while we expect rating agencies to wait for clarity on corporate performance until the second half of 2021.

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

FUND FACTS

Launch date	Base currency	Index
31 July 2020	Euro	Bloomberg Barclays Euro-Aggregate: Corporate Index

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 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.
- Investment in Fixed Income Securities via the China Interbank Bond Market may also entail additional risks, such as counterparty and liquidity risk.
- 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 October 2020 and subject to change daily.

INDEX INFORMATION

The **Bloomberg Barclays Euro-Aggregate: Corporates bond index** is a rules based benchmark measuring investment grade, EUR denominated, fixed rate, and corporate only. Only bonds with a maturity of 1 year and above are eligible.

The **MSCI Euro Credit Corporate Index (ECCI)** includes fixed rate corporate debt denominated in the euro.

The **Bloomberg Barclays U.S. Corporate Index** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market.

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