

Morgan Stanley Investment Funds

Sustainable Euro Strategic 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

There were no material changes in overall credit positioning of the portfolio.

Strategy and Outlook

Strategy:

The Fund is overweight to credit. 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). It has an exposure to green bonds of 25.24% versus 2.44% in the index.

The Fund is overweight to duration.

In currency markets, the Fund is underweight to the U.S. dollar and British pound. It is overweight euro, Norwegian krone, Polish zloty and Australian dollar.

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
31 July 2020

Base currency
Euro

Index
Bloomberg Barclays Euro-Aggregate Index

Share Class I 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 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 fund's 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 Bond Index** is a benchmark that measures the investment grade, euro-denominated, fixed-rate bond market, including treasuries, government-related, corporate and securitized issues. Inclusion is based on currency denomination of a bond and not country of risk of the issuer.

The **MSCI Euro Debt Index** is a broad-based benchmark for the sovereign and credit bond markets. It includes fixed rate debt denominated in the euro, or the various European Economic and Monetary Union (EMU) currencies, and rates as investment grade.

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

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.

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.

Ireland: Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Regulated by the Central Bank of Ireland. **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, Grosse Gallusstrasse 18, 60312 Frankfurt am Main, Germany (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 Branch. 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 accepts 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 publication 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. This publication has not been reviewed by the Monetary Authority of Singapore.

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. Luxembourg 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'Île, 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.