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Morgan Stanley Investment Funds

Sustainable Global High Yield Bond Fund

MARKETING COMMUNICATION | HIGH YIELD TEAM | MONTHLY COMMENTARY | 30 APRIL 2023

Performance Review

In the one month period ending 30 April 2023, the Fund's Z shares returned 0.75% (net of fees)[1], while the benchmark returned 1.23%.

Challenging credit selection in the health care sector was the primary detractor from relative returns during the month. In health care, one of the primary individual detriments to relative performance was a lack of exposure to a volatile specialty pharmaceutical manufacturer that recently spun off its most valuable asset and is facing patent exclusivity headwinds and longer-term solvency risk. This position in the ICE BofA Developed Markets High Yield Excluding Subordinated Financial Index (the Index) partially recovered during the month, although it remains distressed. Adverse credit selection in the containers and diversified financial services sectors also hurt relative performance. However, this was partially offset by an underweight position and credit selection in the cable & satellite TV sector. Positive relative performance in the sector was led by a lack of exposure to a satellite TV provider that is experiencing consistent customer attrition and ongoing cybersecurity issues and whose business has questionable terminal value. This position in the Index was down approximately -5% in April. Favorable credit selection in the diversified media and leisure sectors also helped relative performance.

From a ratings perspective, adverse credit selection in B-rated and BB-rated bonds detracted from relative returns during the month. A modest allocation to cash also hurt relative results in a positive month for global high yield markets. From a country perspective, credit selection in the U.S. hurt while positioning in Germany helped relative performance.

Market Review

Volatility in the global high yield markets receded in April, and the demand for credit risk generally improved amid lackluster secondary trading volume and renewed capital markets activity. Over a four-week period, the U.S. high yield retail market recouped nearly half of the year-to-date outflow, as fear surrounding weakness in regional banks lessened. The initial batch of first quarter earnings releases was generally better than feared, and economic data, in aggregate, was neither too hot nor too cold. Investors took advantage of still historically attractive yields, and the higher-beta segments of the high yield market generally outperformed.

The ICE BofA Developed Markets High Yield Excluding Subordinated Financial Index returned 1.23% in April. The yield-to-worst decreased by 7 basis points (bps) to 8.16%. The spread-to-worst decreased 4 bps to end the month at 476 bps. The top performing sectors for the month were publishing & printing, railroad, and banking & thrifts, while cable & satellite TV, paper, and metals & mining were worst performing.[2]

The lower quality segments of the market generally outperformed in April, after lagging in March. CCC-rated bonds were the best performing segment, while BB-rated bonds were the worst performing segment.[2]

The technical conditions in global high yield markets rebounded in April. The pace of primary issuance in both the U.S. and Europe picked back up in April after slowing considerably amid the volatility in March. Monthly issuance jumped from $5.6 billion in March to $18.8 billion in April in the U.S. while more than €5 billion priced in Europe. Year-to-date issuance increased to $59.3 billion and €21.5 billion, respectively. U.S. and European high yield retail funds both saw positive inflows during the month. According to preliminary Lipper estimates, U.S. high yield retail funds experienced a net inflow of $6.2 billion in April, after experiencing a first quarter outflow of approximately -$16 billion. European high yield retail funds experienced a net inflow of approximately €77 million in April, bringing the year-to-date total inflow to approximately €622 million (or 1.7% of total assets under management).[3]

Default activity in the U.S. and Europe increased during the month. According to J.P. Morgan, the U.S. trailing 12-month par-weighted default rate increased month-over-month to 1.42%. Including distressed exchanges, the U.S. default rate increased to 2.18% in April. The trailing 12-month par-weighted default rate in Europe jumped from 0.4% in March to 1.2% in April. Two issuers restructured their bonds for a combined €3.7 billion.[3]

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1 Source: Morgan Stanley Investment Management Limited. Data as of 30 April 2023.
2 Source: ICE Data Indices. Data as of 30 April 2023.
3 Source: J.P. Morgan. Data as of 30 April 2023.

This document constitutes a commentary and does not constitute investment advice nor a recommendation to invest. The value of investments may rise as well as fall. Independent advice should be sought before any decision to invest.

Portfolio Activity

With an uncertain economic outlook, we continue to re-examine the credit risk across the entire Fund. We continued to favor defensive sectors and higher quality credits, particularly where long-term value is present, and remained inclined to reduce exposure to cyclicals and segments exhibiting asymmetric risk/return characteristics. We have continued to take advantage of primary market issuance to reduce elevated cash balances and added exposure in some higher-rated bonds at large discounts to par.

Strategy and Outlook

We remain cautious on the near-term outlook for global high yield markets as we enter the second quarter of 2023. Episodic weakness accompanied by volatile spread movement seems to be the most likely path forward due to several factors, starting with clear evidence of existing cracks in the U.S. economy and what we view as the increasing likelihood of a hard economic landing and the inevitable reverberations in Europe and beyond. Slowing economic growth across most of the developed market, still elevated inflation and the expectation for further tightening in monetary policy, reduced liquidity, and the declining health of corporate fundamentals are clear headwinds for global high yield markets. Finally, geopolitical risk is not only lurking in the background, but has grown more pronounced.

We are concerned about the lagged effects of the aggressive monetary policy tightening and expect more problematic effects will manifest themselves. Global economic activity has already slowed, and the current pace of deceleration in 2023 is unknown.

Going forward, we see a much more balanced inflation picture, primarily on the back of negative money supply growth. However, current inflation readings remain well above global central banks' target rates and the labor market has not weakened materially, and we expect this combination means that monetary policy will remain a headwind over the near term.

The average corporate fundamentals of high yield issuers are softening but are starting from a point of strength, particularly in Europe where the data continues to strengthen. According to J.P. Morgan, in Europe, fourth quarter earnings indicate the average year-over-year revenue growth and EBITDA margin growth of high yield issuers remain strong.[4] Average leverage has fallen to mid-2019 levels at 4.6x, while interest coverage has fallen slightly from a peak to 6.2x.[3]According to J.P. Morgan (in the U.S.), fourth quarter earnings released in the first quarter indicate the average year-over-year revenue and EBITDA growth of high yield issuers have declined to 8.9% and 11.5%, respectively.[4] The average leverage of high yield issuers increased modestly after nearly two years of sequential quarterly improvement. While average interest coverage increased to yet another record high, interest expense increased more than 8% quarter-over-quarter.[3]

More than 50% of the global high yield market is still BB-rated.[2] Increasing default risk is not sector-specific, though parts of health care (in the U.S.), homebuilders & real estate (in Europe) and the peripheral European banking sector remain in focus for high yield investors. The trailing 12-month par-weighted default rate remains low, but we anticipate it will trend slowly upward by year-end. Near-term maturities remain a bigger problem for European markets than the U.S., and we are watchful of the primary market in coming quarters. The silver lining is that much of the cohort at elevated risk of default is already trading at distressed levels, likely mitigating return degradation on a go-forward basis, in our view.

As episodic volatility persists, we expect our modestly defensive positioning will continue to be of benefit. Capitalizing on pricing inefficiencies and avoiding credit mistakes will be critical in driving outperformance. Geopolitical risk remains elevated, and risk markets have historically done a poor job pricing this risk. Wider peak spreads seem likely in the coming quarters, and we expect entry points to soon emerge where disciplined long-term investors will likely be rewarded for incrementally adding exposure to the asset class.

That said, we believe current yield levels look to offer increasingly fair compensation for the elevated risk in the market.[2]

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

FUND FACTS

Launch date	Base currency	Index
27 April 2017	U.S. dollars	ICE BofA Fixed Income Indices - ICE BofA Developed Markets High Yield Excluding Subordinated Financial Index TR USD

[2] Source: ICE Data Indices. Data as of 30 April 2023.
[3] Source: J.P. Morgan. Data as of 30 April 2023.
[4] Source: J.P. Morgan. Data as of 30 April 2023. EBITDA = Earnings before interest, taxes, depreciation and amortization.

Calendar Year Returns (%)

Past performance is not a reliable indicator of future results.

	YTD	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
Class Z Shares	3.75	-9.07	5.39	4.44	14.45	-1.63	--	--	--	--	--
ICE BofA Fixed Income Indices - ICE BofA Developed Markets High Yield Excluding Subordinated Financial Index TR USD	5.31	-12.63	3.15	7.16	13.41	-3.47	--	--	--	--	--

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

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 is 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.
- 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.
- 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 30 April 2023 and subject to change daily.

Applications for shares in the Fund should not be made without first consulting the current Prospectus and the Key Information Document ("KID") or Key Investor Information Document ("KIID"), which are available in English and in the official language of your local jurisdiction at morganstanleyinvestmentfunds.com or free of charge from the Registered Office of Morgan Stanley Investment Funds, European Bank and Business Centre, 6B route de Trèves, L-2633 Senningerberg, R.C.S. Luxemburg B 29 192.

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