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Morgan Stanley Investment Funds

US Dollar Corporate Bond Fund

GLOBAL FIXED INCOME TEAM | MONTHLY COMMENTARY | 31 JANUARY 2021

Performance Review

In the one month period ending 31 January 2021, the Fund's Z shares returned -1.41% (net of fees)[1], while the benchmark returned -1.28%.

Over the month, the portfolio's overall investment grade positioning detracted from returns, driven primarily by positioning in non-financials. Small overweights to retailers, food & beverage, electric, and media & entertainment detracted from returns. Underweight positioning in consumer non-cyclicals, specifically health care, also negatively impacted performance over the month.

Within financials, an overweight to banking and insurance also detracted. This was partially offset by small off-index allocations to high yield, convertibles and emerging market corporates, which were additive.

Market Review

In anticipation of a strong rebound in growth by the end of 2021, government bond yields across the developed markets moved higher in January, despite the emergence of new, more contagious COVID-19 strains. The "reflation trade" continued to pick up momentum in the markets, as inflation breakevens hit multi-year highs. Following weakness in December, the U.S. dollar strengthened against a basket of currencies amid equity market volatility in January.

In the U.S., the Federal Open Market Committee (FOMC) kept monetary policy unchanged at its January meeting and reinforced its intention to keep policy easy for a long time. Officials also dispelled concerns about tapering too soon lest it may tighten financial conditions prematurely. The Federal Reserve (Fed) also discussed inflation, stating that while inflation is a risk, it's not a "primary" risk. The Fed expects the higher inflation levels that may be seen this year to be transitory. The Fed intends to maintain the current pace of $120 billion of purchases per month until "substantial further progress" has been made on employment and inflation goals. From a fiscal perspective, newly inaugurated President Joe Biden introduced a new $1.9 trillion stimulus program, in addition to the $900 billion stimulus that was agreed in late December. "America's Rescue Plan" includes direct payments to individuals, assistance for small businesses, state and local government aid, and vaccine rollout funding. Data over the month was mixed, as PMIs and housing market data suggested signs of strength, while gross domestic product (GDP) and labor market data pointed to some of the remaining weaknesses in the economy.

In Europe, strict lockdowns and restrictions continued to wreak havoc and threaten the region's recovery, coupled with a slower-than-expected vaccine rollout. After expanding its stimulus program in December, the European Central Bank (ECB) did not make any changes to policy at its January meeting. ECB President Christine Lagarde emphasized that "ample monetary stimulus remains essential" and that the bank remains ready to act if deemed necessary. In its meeting minutes, ECB members disclosed that they are closely watching the appreciation in the euro against the U.S. dollar, highlighting that its appreciation could be a contributor to subdued inflation in the euro area. Lagarde also stated inflation is likely to face downward pressure with weaker demand and lower wage pressures.

In the U.K., although national lockdown measures remained intact, vaccine rollouts have been quite efficient thus far, with over 13% of the population receiving the vaccine to date. Chancellor Rishi Sunak announced a £4.6 billion financial support package targeted at struggling U.K. companies. The package will stay in effect until at least February 15, 2021. Despite this, economic data was weak over the month.

At its January meeting, the Bank of Japan (BoJ) left rates on hold at -0.1% and also maintained its target for the 10-year bond yield at approximately 0%. The BoJ stated that it will continue to target 2% inflation with its current policy and asset buying framework, and does not foresee reducing or eliminating any stimulus or support for the foreseeable future. The central bank did upgrade its economic forecast for the next fiscal year, moving its GDP forecast higher by 0.3% and also raising its core

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 January 2021.

inflation expectations. However, central bank officials did caveat their upgraded forecasts, stating that there are escalating risks to the outlook as emergency coronavirus measures could derail the country's recovery.

Investment Grade:

After a strong end to 2020, risk assets took a breather to begin 2021. Risk-free yields were higher in January, with the U.S. 10-year closing 15 basis points (bps) higher at 1.07%, while core European yields also rose. Equity volatility increased in January, and the major indices ended the month slightly lower. Like the markets, the news flow was mixed as well. The Democratic Party secured control of Congress with victories in the two Georgia runoff elections. This opened the door for another large stimulus package, which would be a pro-cyclical shot in the arm for the U.S. economy. Unfortunately, the fiscal boost may be sorely needed, as new COVID-19 variants and logistical questions over the vaccine rollout have raised the risk of longer lockdowns. In the end, credit markets didn't know which way to go and ended the month nearly unchanged.

The Bloomberg Barclays U.S. Corporate Index (U.S. investment grade index) rallied to an intra-month low of 92 bps over government bonds, but couldn't hold the gains and closed January unchanged at 96 bps. As a result, the index generated total returns of -1.28%. Financials widened by 1 bp, underperforming non-financials, which were flat. Within non-financials, BBB rated names outperformed higher-rated securities by a small margin. At the industry level there was some subtle variation in performance, with most sectors +/-3 bps for the month. In terms of excess returns versus government bonds, the U.S. investment grade index generated a marginally positive excess return of 0.03%. Performance of European investment grade was very similar to the U.S. market. The Bloomberg Barclays Euro-Aggregate Corporate Index (European investment grade index) closed unchanged at 92 bps over government bonds and generated total returns of -0.12%. Financials closed 1 bp wider, underperforming non-financials, which were unchanged. In terms of excess returns versus government bonds, the European investment grade index generated a marginally positive excess return of 0.01%.

On the supply front, roughly $123 billion of new investment grade bonds were issued in January, down 5% year-over-year and 7% below past January averages. The 10 largest deals that came to market accounted for 45% of the total issuance for the month, of which two deals were related to acquisition financing. Merger and acquisition-related debt issuance was $14 billion in January, and we expect this trend to remain prevalent throughout the year as issuers take advantage of historically low funding costs. Supply from the large U.S. banks, a common occurrence in January, came in a little lower than expected, with one large name staying out of the market for the time being. While gross supply was down, signaling that some supply may have been pulled forward into 2020 given the low yields and tight credit spreads in the fourth quarter, we expect supply to pick up once earnings season is behind us. Future supply is expected to be key to market sentiment, with a healthy calendar expected post-fourth-quarter reporting in order to lock in low yields.

Portfolio Activity

While macro and credit fundamentals are pointed in the right direction, valuations are far from exciting. We remain long risk as we believe technicals should push spreads tighter, but are cognizant that the days of strong total returns are likely behind us. As a result, we have continued to move up in quality and liquidity and are carefully considering sector weightings to see where rotation at tight valuations makes most sense.

Strategy and Outlook

Despite the market's lackluster performance to start the year, we continue to see a constructive backdrop for investment grade credit. In our base case, credit spreads remain supported by the vaccine rollout and continued positive support from monetary and fiscal policy, which will make 2021 a year of reflation. Earnings season has just begun, but fourth quarter results from the banks were strong and highlighted the resiliency of the U.S. consumer. We expect credit spreads to move tighter in the short to medium term given this backdrop. A steeper U.S. yield curve and attractive hedging costs for non-U.S. dollar investors should also help bring investors into the market. There are risks of volatility, but we believe any downside is limited by expectations that vaccines will be increasingly deployed in the next few months. With such a supportive backdrop, it is possible that credit spreads overshoot fair value during the first half of 2021, though the outperformance should be limited with spreads already tight versus the long-term average. We expect spreads to give back these gains later in 2021 as tight valuations encounter renewed shareholder-friendly activity, increasing merger and acquisition activity and questions about policy expectations for 2022.

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

FUND FACTS

Launch date	Base currency	Index
20 May 2016	U.S. dollars	Bloomberg Barclays U.S. Corporate Index

12 Month Performance Periods to Latest Month End (%)

	JANUARY '20 - JANUARY '21	JANUARY '19 - JANUARY '20	JANUARY '18 - JANUARY '19	JANUARY '17 - JANUARY '18	JANUARY '16 - JANUARY '17
MS INVF US Dollar Corporate Bond Fund - Z Shares	6.80	16.23	-0.15	4.95	--
Bloomberg Barclays U.S. Corporate Index	5.99	14.53	0.75	5.08	--

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 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.
- 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 January 2021 and subject to change daily.

INDEX INFORMATION

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.

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