Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

US Dollar Short Duration Bond Fund

GLOBAL FIXED INCOME | GLOBAL FIXED INCOME TEAM | MONTHLY COMMENTARY | 31 JULY 2019

Performance Review

In the one month period ending 31 July 2019, the Fund's Z shares returned 0.19% (net of fees)[1], while the benchmark returned 0.06%.

Spread positioning was the main contributor to returns over the month, particularly in investment grade corporates, as spreads continued to tighten. U.S. interest rate positioning was a slight detractor from relative returns, as were non-agency residential mortgage-backed securities.

Market Review

Bond markets and financial markets continued their good run in July: bond yields down, credit spreads tighter, equities up. After May's volatility on the back of bad news about U.S.-China trade negotiations, things seemed to be getting better. And with central bank meetings out of the way by the end of the month, markets were set for a quiet August. Indeed, the S&P 500 equity index hit a new all-time high on July 26 and the Federal Reserve (Fed) cut rates on July 31 for the first time in 11 years. Events looked good for markets on the surface: what happened?

Unfortunately, by the end of the month, the news flow shifted and what looked like a benign August became a lot more interesting. Two things changed. The first is easily reversible. The Fed's cautious 25 basis point (bp) rate cut on July 31 (dare we say a 'hawkish ease') disappointed markets that wanted more; not necessarily more basis points, but more commitment to additional cuts in the future. But this was not fatal to market confidence as we and the market remained confident that the Fed would cut rates further if and when the extent of the economic slowdown became evident.

The second change is not as easily reversed. The sudden escalation of the U.S.-China trade war in early August is a potentially trend-altering dynamic. The initiation of further tariffs on Chinese imports and China's retaliatory actions as they pertain to agricultural goods and the sudden depreciation of the Chinese currency increases global economic risks significantly. Already in early August, U.S. markets are pricing in significant further Fed rate cuts and higher risk premiums on corporate bonds, emerging market debt and equities.

Until now, markets saw the silver lining of 'bad' economic news: it had a silver lining as it would trigger additional monetary stimulus, boosting bond returns, steepening the yield curve and improving business confidence. Thus the phrase 'bad news is good news'. Unfortunately, 'bad news' could really be bad news. We, like the market, believe that this trade war escalation could endanger the health and longevity of the global business cycle. Basically, 'bad news' is bad news when central bankers cannot take enough timely offsetting policy adjustments to offset the impact of trade restrictions. Importantly, central banks will try, even as their monetary ammunition runs low (especially outside the U.S.), to keep the global economy chugging along, no matter what politicians try to do. So, buckle your seat belts, prepare for more volatility, but do not panic. It is too early to tell how this constellation of opposing forces will turn out.

In July, yields on 2-, 5- and 10-year Treasuries rose by 12, 6 and 1 bps, respectively.[2] Thirty-year yields were unchanged.[2]

Corporate bonds performed well in July, helped by the expectation of easy central banks and strong demand. Additionally, second quarter corporate earnings exceeded weak expectations, providing confidence that a downturn is not imminent. The Bloomberg Barclays U.S. Corporate Index spread closed 7 bps tighter in June to end the month at 108 bps over government bonds, with lower-rated credits outperforming.[3]

While valuations have tightened so far in 2019, we would note the market appears to be ignoring a number of signals that macro risk is rising. This includes increased risk of a hard Brexit, the lack of progress on trade negotiations between the U.S. and China, and weak global manufacturing data. Though uncertainty makes the short-term outlook for corporate earnings less clear,

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1 Source: Morgan Stanley Investment Management Limited. Data as of 31 July 2019.
2 Source: Bloomberg L.P. Data as of July 31, 2019.
3 Source: Bloomberg Barclays. Data as of July 31, 2019.

we still think that overall conditions are positive for corporates. Our base case does not call for a recession; rather we expect continued low global growth and low inflation, supported by low real rates and easy financial conditions.

Current coupon agency mortgage-backed securities (MBS) spreads widened 2 bps in July to 64 bps above similar duration U.S. Treasuries.[2] Lower coupon agency MBS outperformed higher coupon MBS as the yield curve flattened and prepayment concerns have a greater negative impact on the higher coupon MBS. Supply pressure from the reduction of the Fed's balance sheet holdings and increasing prepayment concerns from lower mortgage rates have caused agency MBS to underperform credit sectors this year. We think that agency MBS now look more attractive on a risk-adjusted, relative-value basis as credit spreads have tightened materially this year.

Non-agency MBS and asset-backed securities spreads were mostly unchanged in July and remain meaningfully tighter year-to-date. We still believe that securitized asset fundamental credit conditions will remain positive and that credit-sensitive mortgage and securitized assets will continue to perform well, but we have concerns that credit risk is not being priced at appropriate levels.

Portfolio Activity

We continue to think that the compensation in the market for taking credit risk remains superior to that of interest rate risk. Therefore, most of the Fund is invested in short-maturity, investment grade corporate and non-agency securitized bonds. The Fund's overall duration is close to the one-year duration of the benchmark.

Strategy and Outlook

Looking ahead, we expect corporates to generate attractive excess returns, primarily through carry as opposed to capital gains. We do not expect spreads to retest cycle lows given the age of the cycle, the lower quality and longer duration makeup of the market, and questionable technicals. Sector and issuer selection will remain key decisions in 2019 as technology and behavioral change are both fast moving and disruptive for many traditional industry business models. These concerns, coupled with absolute valuations, will likely keep us cautious and tactical with our additions and subtractions of risk in the near future.

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

FUND FACTS

Launch date	Base currency	Index
22 April 2016	U.S. dollars	ICE BofAML 1-Year U.S. Treasury Note Index

12 Month Performance Periods to Latest Month End (%)

	JULY '18 - JULY '19	JULY '17 - JULY '18	JULY '16 - JULY '17	JULY '15 - JULY '16	JULY '14 - JULY '15
MS INVF US Dollar Short Duration Bond Fund - Z Shares	3.73	1.30	1.32	--	--
ICE BofAML 1-Year U.S. Treasury Note Index	2.91	0.92	0.54	--	--

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.**

Effective August 1, 2019, the Fund's primary benchmark index will change to the Bloomberg Barclays 1-3 Year U.S. Government/Credit Index. In addition, the Fund's average duration target will change from 1 year or less to 3 years or less. See prospectus for details.

[2] Source: Bloomberg L.P. Data as of July 31, 2019.

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 low 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 July 2019 and subject to change daily.

INDEX INFORMATION

The **ICE BofAML 1-Year U.S. Treasury Note Index:** is an unmanaged index tracking U.S. government securities with a maturity of at least one year and less than three years.

The **Standard & Poor's 500® Index (S&P 500®)** measures the performance of the large cap segment of the U.S. equities market, covering approximately 80% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

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 1-3 Year U.S Government/Credit Index** tracks the securities in the 1-3 year maturity range of the Barclays U.S. Government/Credit Index which tracks investment-grade (BBB-/Baa3) or higher publicly traded fixed rate U.S. government, U.S. agency, and corporate issues.

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