Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund

Emerging Markets Fixed Income Opportunities Portfolio

GLOBAL FIXED INCOME | GLOBAL FIXED INCOME TEAM | COMMENTARY | MARCH 31, 2019

Performance Review

In the quarter period ending March 31, 2019, the Portfolio's I shares returned 6.34% (net of fees)[1], while the benchmark returned 4.90%.

Relative performance during the quarter was aided by positioning in dollar-denominated sovereign and corporate debt, as well as domestic sovereign debt. In particular, overweight positions in Mexico, Indonesia, Nigeria, Venezuela, Colombia and Brazil contributed. Conversely, domestic debt exposure in Turkey, Romania and Poland detracted from performance in the period.

The broader emerging market (EM) debt market returned 0.47% in the quarter as measured by the Blended Index, an equal-weighted index comprised of the JP Morgan GBI-EM Global Diversified Index (domestic debt), JP Morgan EMBI Global Index (external debt) and the JP Morgan CEMBI BD Index (corporate debt). EM external debt led the way with a return of 1.45%, followed by corporate debt returning 1.28%, while domestic debt trailed with a return of -1.33% as currencies weakened versus the U.S. dollar.

Market Overview

EM fixed income assets rebounded in the first quarter after a tough 2018. Hard currency assets outperformed local currency bonds as EM currencies only marginally appreciated versus the U.S. dollar. Within the hard currency segment, high yield outperformed investment grade and sovereigns outperformed corporates. Commodity prices were broadly positive in the period, with continued strength in oil prices and a more mixed picture in precious metals and agricultural commodities. Investment flows started the year off strong as investors allocated $36 billion into EM fixed income during the month, according to JPMorgan. The inflows were roughly split between institutional and retail flows, primarily in favor of hard currency strategies, followed by local currency and then blended.

In Latin America, political clashes in Brazil raised questions among investors about President Bolsonaro's ability to negotiate with congress and make progress on his fiscal reform agenda. These concerns were exacerbated by reports that the president's popularity rating fell from 49% in January to 35% in March[2]. In Brazil, a comprehensive social security reform is needed to address negative fiscal dynamics and slow the growth of debt-to-gross domestic product (GDP). In response to increasing inflation and peso depreciation, the central bank of Argentina continued tightening monetary policy through conventional rate hikes and regulatory changes. The latest measures include a change of bank limits, designed to narrow the gap between the policy (Leliq) and interbank/deposit (Badlar) rates, thus improving the transmission of monetary policy. Headline and core inflation in the country accelerated above market expectations, to 3.8% month-over-month and 3.9% month-over-month, respectively[2]. Meanwhile, the trade balance continued to improve with imports declining 25% year-over-year and exports increasing 4% year-over-year in February[2]. Elsewhere in Latin America, the International Monetary Fund's Executive Board approved a $4.2 billion Extended Fund Facility for Ecuador with an immediate disbursement of $652 million. The arrangement provides support to Ecuador for the next three years. In addition, Ecuador has negotiated close to $6 billion of additional assistance from multilaterals. In Mexico, the government stated that it would use its stabilization fund to increase support for Pemex, the state-owned oil company, which was downgraded two credit notches by Fitch to BBB-. Brazilian miner Vale was also downgraded following a dam breach that left a death toll in the hundreds. The loss of investment grade credit ratings would

1 Source: Morgan Stanley Investment Management. Data as of March 31, 2019.
2 Source: Bloomberg L.P. Data as of March 31, 2019.

prompt forced selling by ratings-sensitive investors, which would weaken demand for the debt. Inflation in Mexico slowed to within the central bank's target range, increasing the hopes for a rate cut later this year, as already priced by the market. The central banks in Mexico, Peru and Brazil held rates steady in their last meetings. Venezuelan President Nicolas Maduro faced one of the strongest tests of his presidency as Juan Guaido, the leader of the National Assembly, organized massive street protests to challenge his position. During his speech, Juan Guaido declared himself the legitimate leader of the country and was recognized as such by most of the Americas and a multitude of countries across the globe. However, since the initial declaration in January, progress has slowed as the opposition works to force a peaceful transition. Most of the senior leaders of the military have publicly supported Maduro, with only one defection publicly backing Guaido. The U.S. and Venezuela have sparred diplomatically, and the U.S. has placed sanctions on the trading of Venezuelan debt. Venezuelan bonds, currently in default, rallied strongly on the potential for a change in government.

In Europe, Turkish assets continued to underperform after falling net reserve data suggested that the central bank was using reserves to support the lira ahead of local elections. The ruling AKP party had a poor showing in the municipal elections, losing Ankara and possibly Istanbul. In the run up to the elections, the central bank reportedly barred local banks from providing lira liquidity to international banks, sending the overnight offshore swap rate upward to over 1000%[2]. This not only prevented offshore participants from shorting the currency, but also prevented offshore investors from rolling their currency hedges – creating pressure for these investors to sell their positions. Authorities also opened an investigation into JP Morgan for publishing a negative strategy note about the currency, raising concerns over the potential for a wider clampdown on independent research. During the period, the Turkish Central Bank also maintained its policy rate of 24%, citing upside risks from administered prices and still-high inflation expectations. Inflation in Central and Eastern European countries generally surprised to the upside. Romania's consumer price index (CPI) inflation stood at 3.83% year-over-year versus 3.45% expected and Czech Republic's inflation was 2.7% year-over-year versus 2.6% expected[2]. In Poland, the monthly inflation data was the main surprise at 0.4% month-over-month versus 0.1% consensus[2]. The National Bank of Poland increased its growth forecast while lowering its expectation for inflation, maintaining a dovish bias even after accounting for the upcoming fiscal expansion. The National Bank of Hungary hiked the depo rate by 10 basis points (bps) to -0.05%, mostly in line with consensus. However, the statement was more dovish than expected. In Ukraine, comedian Volodymyr Zelensky and incumbent Petro Poroshenko, both viewed favorable by the market, advanced to the second round in presidential elections.

In Asia, China's National People's Congress concluded in March. Premier Li reiterated that the downward economic pressure would be met with targeted and measured easing. This is expected to include lower loan rates, cuts to taxes (value added tax included), and easing market access and creating a more competitive market. The government also lowered its growth target to 6.0% to 6.5% and announced fiscal easing via additional tax cuts. Indonesia's government is targeting a growth rate of 5.3% to 5.5% for 2020 in the state budget released in the March. The government also recently signed a free trade deal with Australia and is close to finalizing deals with Iran, Turkey and the European Union. Indonesia also reported a surprise trade surplus (+$330 million) for February versus expectations of a -$782 million deficit[2]. Both exports and imports contracted further than expected on a year-over-year basis. Bank Indonesia (BI) held rates unchanged at 6%, driven by the BI's objective of reducing external vulnerabilities and preserving the attractiveness of rupiah-denominated assets. Thailand held general elections on March 24 in which the military junta's party (PP) beat Thaksin's PT party in the popular vote. However, many "irregularities at the polls" were reported and even the Election Commission said its website was hacked. In the Philippines, at the central bank meeting chaired by the new governor, the policy rate was kept unchanged at 4.75%, while keeping the required reserve ratio for banks unchanged, despite market expectations for a reduction. Malaysia's central bank also held rates steady at 3.25%, as expected, and reported that foreign ownership of debt rose in March, the first increase since October.

In the Middle East and Africa region, the South Africa Reserve Bank held rates steady, as expected. Notably, however, it revised down its 2019 growth forecast from 1.7% to 1.3%. South Africa CPI printed at 4.1%, remaining below the middle point of the central bank's inflation target[2]. Electricity loadshedding continued, as the government and the state-owned electric utility, Eskom, struggled to contain operational issues, presenting downside risks to growth. Moody's held South Africa's credit rating steady at Baa3, the last of the three major agencies to hold it at investment grade, while cutting Oman's rating to junk on weakening fiscal metrics. The Central Bank of Egypt also kept rates on hold, while markets had expected another 100 bp cut.

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2 Source: Bloomberg L.P. Data as of March 31, 2019.

Fund Strategy and Performance

During the period we added to active positions in Peru, Qatar, Argentina, Ecuador, Azerbaijan, Russia, Sri Lanka, Paraguay and Brazil. Conversely, we reduced in Guatemala, Egypt, Dominican Republic, Panama, Kazakhstan, Nigeria, Costa Rica, Jamaica, South Africa, Mexico, Ukraine and Kenya. From a currency perspective, we reduced in South Africa while adding in Peru, Nigeria and Argentina.

Outlook

Despite recent softness in global growth and potentially market-disruptive events (in the near term, most notably Brexit), our outlook for EM debt remains constructive due to several factors. First, global monetary policy has decidedly turned accommodative, as emphasized by the recent dovish turn by the Federal Reserve and an easing bias by the European Central Bank. All other things equal, this should increase the attractiveness of higher yielding EM assets. In addition, China continues to provide significant stimulus via monetary easing (through reserve requirement ratio cuts and enlarged liquidity facilities) and fiscal expansion (via tax cuts and increased infrastructure spending by local governments). Third, the U.S.-China trade conflict, a major source of uncertainty last year, appears to be heading towards a provisionary agreement in the next few months, potentially boosting sentiment for risky assets in the near term.

Notwithstanding our positive outlook, several risks on the horizon prevent us from being uniformly bullish. Most notably, further global growth weakness, particularly in the eurozone and China, could cause risk aversion to spike and the dollar to strengthen, weighing negatively on EM assets. Similarly, failure to reach an agreement in U.S.-China trade talks could negatively impact global trade flows. EM risks are more balanced. On the positive side, continued economic and diplomatic pressure by the U.S. and its allies on the Maduro regime could eventually open the door to a market-friendly regime change (and debt restructuring) in Venezuela. In Brazil, we remain optimistic about a successful social security reform that, despite some dilution, will achieve sizable savings in the next 10 years. On the negative side, a more pronounced slowdown in China's activity could be detrimental to trade-intensive EM economies. Finally, key elections in Turkey, Ukraine, South Africa, India and Argentina could put pressure on domestic assets, though broad contagion effects to the entire EM debt universe are likely to be contained.

FUND FACTS

Launch date	Base currency	Index
May 24, 2012	U.S. dollars	Blended Index

Performance (%)

As of March 31, 2019 (Class I Share at NAV)

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF Emerging Markets Fixed Income Opportunities Portfolio - I Shares	0.22	6.34	6.34	-2.15	5.57	4.42	--	4.36
Blended Index	0.47	4.90	4.90	0.12	4.77	4.68	--	4.87

Performance data quoted represents past performance, which is no guarantee of future results, and current performance may be lower or higher than the figures shown. For the most recent month end performance figures, please visit morganstanley.com/im. Investment returns and principal value will fluctuate and fund shares, when redeemed, may be worth more or less than their original cost.

The gross expense ratio is 2.01% for Class I shares and the net expense ratio is 0.84%. Where the net expense ratio is lower than the gross expense ratio, certain fees have been waived and/or expenses reimbursed. These waivers and/or reimbursements will continue for at least one year from the date of the applicable fund's current prospectus (unless otherwise noted in the applicable prospectus) or until such time as the fund's Board of Directors acts to discontinue all or a portion of such waivers and/or reimbursements. Absent such waivers and/or reimbursements, returns would have been lower. Expenses are based on the fund's current prospectus. The minimum initial investment is $5,000,000.

Returns are net of fees and assume the reinvestment of all dividends and income. They are compared to an unmanaged market index. Returns for less than one year are cumulative (not annualized). Performance for one year or more is based on average annual total returns. The returns are reported for Class I shares. Performance for other share classes will vary.

The Blended Index is comprised of **1/3 JP Morgan Emerging Markets Bond Index Global** (tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the EMBI+. As with the EMBI+, the EMBI Global includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million), **1/3 JP Morgan GBI-EM Global Diversified Index** (a comprehensive global local emerging markets index that consists of regularly traded, liquid fixed-rate, domestic currency government bonds and includes only the countries which give access to their capital market to foreign investors (excludes China, India). The index is market capitalization weighted, with a cap of 10% to any one country) and **1/3 JP Morgan CEMBI Broad Diversified Index** (a global, liquid corporate emerging-markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging-markets entities). The returns shown prior to September 28, 2015 are that of the **JP Morgan Emerging Markets Bond Index Global**, the fund's benchmark prior to the merger. Returns since the merger are that of the Blended Index. These indices are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

RISK CONSIDERATIONS

There is no assurance that a mutual fund will achieve its investment objective. Funds are subject to market risk, which is the possibility that the market values of securities owned by the fund will decline and that the value of fund shares may therefore be less than what you paid for them. Accordingly, you can lose money investing in this fund. Please be aware that this fund may be subject to certain additional risks. **Fixed-income securities**are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In the current rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. **Longer-term securities**may be more sensitive to interest rate changes. In a declining interest-rate environment, the portfolio may generate less income. **Mortgage- and asset-backed securities**are sensitive to early prepayment risk and a higher risk of default and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. Certain **U.S. government securities** purchased by the Strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **High yield securities ("junk bonds")**are lower rated securities that may have a higher degree of credit and liquidity risk. **Public bank loans**are subject to liquidity risk and the credit risks of lower rated securities. **Foreign securities**are subject to currency, political, economic and market risks. The risks of investing in **emerging market countries**are greater than risks associated with investments in foreign developed countries. **Sovereign debt**securities are subject to default risk. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Due to the possibility that prepayments will alter the cash flows on **Collateralized mortgage obligations (CMOs)**, it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third party guarantees are insufficient to make payments, the portfolio could sustain a loss.

INDEX INFORMATION

The **JP Morgan Emerging Markets Bond Index Global (EMBI Global)** tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the EMBI+. As with the EMBI+, the EMBI Global includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million.

The **JP Morgan CEMBI Broad Diversified Index** is a global, liquid corporate emerging-markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging-markets entities.

The **JP Morgan GBI-EM Global Diversified Index** is a comprehensive global local emerging markets index that consists of regularly traded, liquid fixed-rate, domestic currency government bonds and includes only the countries which give access to their capital market to foreign investors (excludes China, India). The index is market capitalization weighted, with a cap of 10% to any one country.

IMPORTANT INFORMATION

The views and opinions expressed are those of the investment team at the time of writing 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 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.

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Certain information herein is based on data obtained from third party sources believed to be reliable. However, we have not verified this information, and we make no representations whatsoever as to its accuracy or completeness.

Please consider the investment objectives, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus, contact your financial advisor or download one at morganstanley.com/im. Please read the prospectus carefully before investing.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

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