Market Overview

The third quarter of 2017 was positive for risk assets. Global credit traded stronger over the period, as spreads tightened across investment-grade and high-yield markets. While August reset valuations in the market, the remainder of the quarter was defined by a steady grind tighter in credit fueled by strong technicals, a positive macroeconomic backdrop, low volatility and strong equity performance. Emerging markets fixed income asset returns were positive in the quarter with a weakening U.S. dollar (USD) and local bond returns contributing to the outperformance of domestic debt, which outpaced dollar-denominated external and corporate debt. Over the quarter, yields on 2-, 5-, 10- and 30-year Treasuries rose by 10, 5, 3 and 3 basis points, respectively.\(^1\) Swap spreads tightened, with 10- and 30-year spreads declining 2 and 3 basis points, respectively.\(^1\) Inflation-linked Treasuries outperformed nominal bonds, as the 10-year breakeven yield rose 12 basis points.\(^1\)

Economic data continued to be strong or surprise to the upside in both the U.S. and Europe in the third quarter, while inflation remains low and central banks appear set on a slow and deliberate path towards normalization. The demand for positively yielding assets remains robust and continued to support the asset class throughout the quarter. Volatility, as measured by the VIX volatility index, remained low, which further supported spreads throughout the period. Energy prices rose in the quarter, mitigating year-to-date losses for oil and coal prices, while prices for many hard commodities such as gold, silver and platinum continued to rise. Soft commodities were mixed with prices for corn, wheat and cotton falling, while soybean and sugar prices fell.

The confluence of these macroeconomic factors drove credit spreads tighter in the quarter. The average spread of the Bloomberg Barclays U.S. Corporate Index contracted 8 basis points, from 109 to 101.\(^2\) Spread tightening in credit markets was broad-based, as every sector and rating category traded tighter relative to Treasuries. Financials slightly outperformed non-financials. The energy and commodity sectors traded particularly well over the course of the quarter, while higher-rated sectors such as capital goods did relatively less well. Cable and media names lagged on merger concerns. Subordinated financials continued their steady move tighter, as the market continued to reach for yield.

In the United States, economic data remains consistent with lower growth and lower inflation, conditions which are generally positive for credit. We expect the U.S. Federal Reserve (Fed) to gradually remove excess accommodation, but do not expect conditions to tighten dramatically. U.S. banks remain strong from a fundamental perspective after years of de-risking, shoring up balance sheets and increasing their liquidity.

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\(^{1}\) Source: Bloomberg, data as of September 30, 2017

\(^{2}\) Source: Bloomberg Barclays, data as of September 30, 2017
profiles. While we no longer expect a significant amount of de-risking from these issuers, we believe they will remain much more favorably positioned than non-financials. We remain modestly concerned with the rise of leverage at U.S. non-financial companies. Specifically, this rise in leverage relative to our place in the business cycle is atypical from a historical perspective, as we traditionally see current leverage levels only in an expansionary phase.

Within Europe, low rates and structural reforms have helped the economy gradually outperform expectations while permitting policy to remain accommodative. Additionally, after years of political uncertainty, European Union (EU) politics have become relatively less eventful compared to those in the U.S. Macron’s majority in France, coupled with Merkel’s recent victory in Germany, should open the door to renewed Franco/German cooperation on a pro-growth/EU integration agenda. The recovery of European banks has been slower than that of the large U.S. issuers, and de-risking continues amid some regulatory uncertainty. On the non-financial side, while the macroeconomic backdrop mentioned above is supportive, valuations are stretched due to continued central bank intervention.

Agency mortgage-backed securities (MBS) outperformed during the quarter, while credit-related securitized assets continued their outperformance of 2017. Spreads on current coupon agency MBS tightened 9 basis points to 56 basis points above interpolated Treasuries, while option-adjusted spreads (OAS) tightened 7 basis points versus the Treasury curve as volatility and prepayment concerns remain subdued. The Fed purchased approximately $25 billion agency MBS in September in order to maintain its agency MBS portfolio at $1.75 trillion, however the Federal Open Market Committee (FOMC) statement from the September meeting confirmed that the Fed would begin to taper its MBS reinvestments beginning in October. The Fed purchased almost $400 billion agency residential mortgage-backed securities (RMBS) in 2016, and are on pace for over $300 billion in 2017, but we believe that ending or slowing this reinvestment will likely have a significant negative impact on agency MBS.

Non-agency MBS spreads continued their tightening trend, extending the strong gains of 2017, while cash flow and credit performance continue to improve. Fundamental U.S. housing market and mortgage market conditions remain positive. National home prices were up 0.7% in July, and are up 5.9% over the past year. Despite the recent increases in home prices, U.S. homes remain affordable from a historical perspective when comparing median incomes against the cost of owning a median-priced home.

Commercial mortgage-backed securities (CMBS) spreads also tightened during the quarter, with both AAA and BBB- spreads roughly 5 basis points lower. Negative retail news continued to weigh on the CMBS sector with Toys R Us being the latest major retailer to file for bankruptcy. Uncertainty over impacts from Hurricanes Harvey, Irma and Maria also continued to put some pressure on CMBS. Spreads for non-retail and non-

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3 Source: JPMorgan, data as of September 30, 2017
4 Source: Federal Reserve
5 Source: National Association of Realtors, data as of September 30, 2017
6 Source: Bank of America/Merrill Lynch, data as of September 30, 2017
hurricane-affected CMBS generally continued to perform reasonably well. Overall, AAA CMBS are roughly 10 basis points tighter on the year, and BBB- CMBS are roughly 50 basis points tighter year-to-date.5

Fund Strategy and Performance

The Fund’s macroeconomic and sector positioning aided performance during the three-month period. Macroeconomic positioning helped performance for the quarter, driven primarily by exposure to peripheral European (Portugal), as well as emerging markets (primarily Brazil), rates and currencies. Exposure in the U.S. also contributed to performance. This was partially offset by core rate hedges in Germany, as well as exposure to the Australian dollar and Mexican peso. Within the credit space, exposure to investment-grade corporates, high yield bonds, convertibles and emerging market external debt helped performance. While in securitized debt, the allocation to U.S. non-agency RMBS and CMBS continued to be positive for the quarter. Short credit default swap positions also detracted from performance in the quarter.

During the quarter we reduced our overall interest rate duration, as well as our long emerging markets currency and short Australian dollar exposure to reduce our USD underweight. We also trimmed exposure to high-yield corporates, securitized debt and emerging markets domestic debt. We also added to peripheral developed market debt and emerging market external debt.

Outlook

The biggest macroeconomic event for September is what looks to be a change in the Fed’s reaction function, i.e., how its policy decisions will be made based on the economic climate. The big change is that the Fed is underweighting the sharp drop in inflation since February 2017, calling it “noise” and overweighting market indicators such as equities, credit spreads, level of the USD and level of U.S. Treasury yields (a.k.a. financial conditions) under the guise of financial stability. Financial conditions have been loosening for most of the year despite hikes by the Fed, which would suggest that Fed policy should be even tighter.

Though low inflation justified a dovish stance in 2016, many FOMC members are now insistent on looking through low headline consumer price index (CPI) prints. For example, at a speech in Cleveland, Fed Chair Yellen spoke about how much of the inflation shortfall is not attributable to slack but to “other” factors, which are temporary (such as telecom prices). The Fed actually developed a new inflation measure—the Underlying Inflation Gauge (UIG). This UIG measure shows underlying inflation at 2.7%. When the data is uncooperative, come up with new data.

The Fed is not alone. Central banks around the world are also changing, focusing more on financial stability. The Bank of Canada has hiked rates twice this year, and Norgesbank and the Bank of England signaled that some tightening will be warranted in their latest policy meetings. In these economies, low rates have contributed to higher leverage in the system, especially in consumer debt. As growth improves and markets remain well-behaved, this has provided central banks the cover to tighten policy and tame financial excesses.
If a change in Fed reaction function is underway, we believe the biggest re-pricing could come through the dollar. While 10-year rates have been range-bound this year, the trade-weighted dollar has decreased by 9% this year, and so could reverse rapidly.⁷ We think trimming currency risk in developed market and emerging market currencies and rotating into the USD is justified.

We expect more clarity in October on tax reform. The White House’s tax proposals provided broad directions, but details remain to be hashed out. Since Congress will likely use reconciliation to pass tax reform, the debate must solidify soon (October) so that major tax measures could be passed with the budget bill in November. Market odds of tax reform passage have declined substantially—a strong tax bill would likely drive U.S. rates higher. Our bias is to remain moderately short rates.

Risky assets have benefited from low rates and improving global growth. We think growth momentum continues as positive numbers from the Purchasing Managers Index (PMI) survey translate to higher capital expenditure and spending. However, ahead of a changing Fed and tax debate, our inclination is to opportunistically take profit on risk positions.

⁷ Source: Bloomberg L.P., data as of September 30, 2017
## Performance (%)

As of September 30, 2017

<table>
<thead>
<tr>
<th>Fund Name</th>
<th>MTD</th>
<th>QTD</th>
<th>YTD</th>
<th>1 YEAR</th>
<th>3 YEAR</th>
<th>5 YEAR</th>
<th>10 YEAR</th>
<th>SINCE INCEPTION 7/28/97</th>
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</thead>
<tbody>
<tr>
<td>Morgan Stanley Global Fixed Income Opportunities Fund</td>
<td>0.61</td>
<td>1.86</td>
<td>6.33</td>
<td>6.38</td>
<td>3.32</td>
<td>4.18</td>
<td>5.18</td>
<td>4.38</td>
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<tr>
<td>Bloomberg Barclays Global Aggregate Index*</td>
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<td>0.78</td>
<td>2.22</td>
<td>-0.17</td>
<td>3.13</td>
<td>3.07</td>
<td>4.30</td>
<td>5.18</td>
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<tr>
<td>Blended Index*</td>
<td>-0.46</td>
<td>0.78</td>
<td>2.22</td>
<td>-5.01</td>
<td>0.00</td>
<td>-0.30</td>
<td>2.91</td>
<td>4.45</td>
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<tr>
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<td>1.30</td>
<td>0.48</td>
<td>3.31</td>
<td>4.65</td>
</tr>
</tbody>
</table>

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 0.60% for Class I shares and the net expense ratio is 0.60%. 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.

*Effective January 1, 2017, the benchmark index for the MS Global Fixed Income Opportunities Fund changed from Bloomberg Barclays Global Aggregate Index to the Bloomberg Barclays Global Aggregate Hedged USD Index. Blended Index performance shown is calculated using the Bloomberg Barclays Global Aggregate Index from inception through 12/31/2016 and the Bloomberg Barclays Global Aggregate Hedged USD Index thereafter.
The views and opinions expressed are those of the portfolio management 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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The Bloomberg Barclays Global Aggregate Hedged Index provides a broad-based measure of the global investment grade fixed-rate debt markets. Total Returns shown is hedged USD.

The Bloomberg Barclays Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. Total Returns shown is unhedged USD.

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

The Indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an Index.

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.

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