Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley Institutional Fund Trust

High Yield Portfolio

GLOBAL FIXED INCOME | GLOBAL FIXED INCOME TEAM | COMMENTARY | JUNE 30, 2020

Performance

The Fund has had a challenging start to 2020. In the first quarter period ending June 30, 2020, the Fund's I shares returned 10.05% (net of fees)[1], underperforming the benchmark return of 10.18% for the same time period.

This brings year-to-date performance to -7.58% (I shares net of fees) versus the index, which returned -3.80%.

The portfolio's performance continues to recover. While large exchange-traded fund (ETF) names had been the early outperformers of the rally, smaller second-tier names have been starting to move higher recently, as many of the larger ETF names trade at very tight levels and investors bargain hunt.

In a reversal of what occurred in the first quarter, generally any sectors the portfolio was overweight added to performance in the second quarter, while underweight positioning detracted. Underweights to technology, communications and financials partially offset strong performance from the building materials, diversified manufacturing, gaming, retail and food & beverage sectors. The largest detractor over the quarter was the Fund's underweight positioning to energy, particularly some fallen angel credits, which rallied on the back of an improving commodity backdrop. A small off-index allocation to bank loans contributed positively to returns.

Looking at the high yield market as a whole, it has now retraced almost all of the spread widening. Year-to-date returns for the Bloomberg Barclays U.S. Corporate High Yield Index are down just about 4%, after being down close 19% in mid-March, and spreads are now inside of 700 basis points (bps) after gapping out as wide as 1100 bps.[2] Large ETF-eligible names and fallen angels have rallied back and recovered in record time.

However, the middle-market space has lagged on the recovery and, although this is typical, this technical has been exacerbated by the Federal Reserve's (Fed) entry into high yield. Ultimately, while many parts of the high yield market have rallied significantly, we believe there is meaningful value in middle-market high yield, and we think it may benefit from a compression trade as investors look for remaining value. In our view, this presents a compelling entry point for investors with a longer time horizon.

Market Review

Markets enjoyed a historic bounce back in the second quarter of 2020, after a volatile COVID-19 and lockdown-driven first quarter. In April, high yield bonds rebounded sharply as the Fed expanded the scope of its corporate credit facilities to include eligible fallen angels and high yield ETFs. Although the Fed did not begin purchasing high yield ETFs until mid-May, this announcement sent high yield ETFs soaring, with the largest high yield ETF (based on assets under management) gaining over 6% in one single day.[3]

Unprecedented monetary relief measures, in addition to some better-than-expected economic data, has helped fuel a sharp rally that continued through May and most of June, although concerns over an acceleration of virus infections began to weigh on investors during the last two weeks of the quarter. The Bloomberg Barclays U.S. Corporate High Yield Index returned over 10%

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1 Source: Morgan Stanley Investment Management. Data as of June 30, 2020.
2 Source: Bloomberg Barclays. Data as of June 30, 2020. One basis point = 0.01%
3 Source: iShares

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in the second quarter, the strongest quarterly returns in over a decade. Spreads tightened 254 bps to end the quarter at 626 bps, and yields fell 257 bps to 6.87%.[2]

On a year-to-date basis, spreads and yields are 290 bps and 163 bps wider. Since March 23, spreads and yields are 474 bps and 482 bps tighter.[2]

Over the quarter, BBs outperformed, returning 11.54%, followed by CCC and B-rated credits, which returned 9.10% and 8.64% respectively.[2] On a year-to-date basis, higher-quality bonds are significantly outperforming lower-quality credit, with BBs just slightly positive at +0.21%.[2] Single Bs and CCCs are down -5.45% and -13.32% year-to-date.[2]

The new issue calendar remains robust and set new records in the second quarter. The second quarter's $145.5 billion of gross and $75.5 billion of net issuance exceed the prior records of $121.2 billion in the second quarter of 2014 and $52.6 billion in the first quarter of 2015, respectively.[4] High yield new issue volume totals $218 billion year-to-date, or $94 billion net of refinancing, which is up 53% and 95% year-over-year.[4]

New issue was absorbed well by the market, as the high yield asset class continues to see record inflows. The Fed continues to make use of the Secondary Market Corporate Credit Facility (SMCCF). As of June 30, the Fed's SMCCF ETF portfolio has a market value of $9.8 billion.[5] Of the $9.8 billion in the facility, $8 billion is invested in ETFs, split between 12% high yield and 88% investment grade.[5] The remaining $1.8 billion is invested across 312 corporate bonds, 14 of which are high yield.[5] However, as of June 30, one single fallen angel (Ford) accounts for over 80% of the Fed's high yield holdings by market value.[5] (As of June 30, Ford was 0.7% of the Fund's portfolio.)

In the second quarter, the total amount affected by defaults or distressed transactions was $82.2 billion, exceeding the combined total of $80.5 billion in the first quarter of 2009 as the largest on record.[4] The par-weighted U.S. high yield default rate is now at a 10-year high of 6.19%, which is up 356 bps from the start of the year, and up 473 bps from the end of June last year.[4]

Portfolio Strategy and Analysis

We have been participating in the new issue calendar actively, which continues to present attractive opportunities, as new issue premiums have been high and new bonds have generally traded well.

We have had added some higher-quality fallen angels and sold several credits that we deemed to be near-term default risk.

Outlook

We expect to see a meaningful increase in overall defaults in the coming year due to a significantly weaker economy stemming from the outbreak, as well as stress in the energy sector. We have seen default rates tick up to over 6% in June, and current street estimates vary between 8% and 12% going forward. We expect all to be heavily concentrated in energy and coronavirus-impacted sectors, so getting sector positioning right will be critical for performance over the coming months. We believe energy could account for half or more of the defaults in the U.S. market.

One of the defining features of this default cycle is that you could see very high recovery rates across select industries and sectors, particularly in COVID-19-related sectors that had a temporary shock to revenues and lack of liquidity. However, industries like energy, where recoveries ultimately may depend on a terminal value of reserves, will likely see very low recoveries.

That being said, volatility in the energy sector will present both problems and opportunities. The current commodity environment is in many ways similar to 2016, when energy was both the highest-defaulting sector and the highest-returning sector. We are already seeing this play out in the second quarter, with commodity-related sectors outperforming. Certain fallen angel energy credits may also present an opportunity to add higher-quality risk at attractive levels.

While June and the second quarter generated stellar returns, an alarming rise in infection rates in several large U.S. states and outbreaks in countries exiting lockdowns risk backsliding on the economy. The U.S. presidential election and U.S.-China relations represent another set of issues independent of the pandemic. On the positive side, progress on vaccines and/or therapeutics could generate upside economic and financial surprises. There is lots to think about, but we remain optimistic that high yield will continue to move tighter over the longer term. Historically, when spreads have widened by this magnitude, the subsequent recovery was significant.

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2 Source: Bloomberg Barclays. Data as of June 30, 2020. One basis point = 0.01%
4 Source: JP Morgan. Data as of June 30, 2020.
5 Source: Bank of America. Data as of June 30, 2020.

FUND FACTS

Launch date	Base currency	Index
February 07, 2012	U.S. dollars	Bloomberg Barclays U.S. Corporate High Yield Index

Performance (%)

As of June 30, 2020 (Class I Share at NAV)

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MSIF High Yield Portfolio - I Shares	1.78	10.05	-7.58	-3.70	2.26	3.74	--	6.35
Bloomberg Barclays U.S. Corporate High Yield Index	0.98	10.18	-3.80	0.03	3.33	4.79	--	5.68

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 0.98% for Class I shares and the net expense ratio is 0.65%. 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.

Please keep in mind that high double-digit returns are highly unusual and cannot be sustained. Investors should also be aware that these returns were primarily achieved during favorable market conditions.

RISK CONSIDERATIONS

There is no assurance that a Portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the Portfolio will decline and that the value of Portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this Portfolio. Please be aware that this Portfolio 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 a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. **High yield securities ("junk bonds")** are lower rated securities that may have a higher degree of credit and liquidity risk. **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. **Public bank loans** are subject to liquidity risk and the credit risks of lower rated securities. **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. **Distressed and defaulted securities** are speculative and involve substantial risks in addition to the risks of investing in junk bonds. The Portfolio will generally not receive interest payments on the distressed securities and the principal may also be at risk.

These securities may present a substantial risk of default or may be in default at the time of investment, requiring the portfolio to incur additional costs. **Preferred securities** are subject to interest rate risk and generally decreases in value if interest rates rise and increase in value if interest rates fall. **Mezzanine investments** are subordinated debt securities, thus they carry the risk that the issuer will not be able to meet its obligations and they may lose value. **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.

INDEX INFORMATION

The **Bloomberg Barclays U.S. Corporate High-Yield Index** measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The Index excludes emerging market debt. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

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 objective, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus, download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

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

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