Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley

Mortgage Securities Trust

GLOBAL FIXED INCOME TEAM | COMMENTARY | CLASS I SHARES | JUNE 30, 2021

Performance Review

In the quarter period ending June 30, 2021, the Portfolio's I shares returned 1.35% (net of fees)[1], while the benchmark returned 0.33%.

The Fund performed well during the quarter, both on a relative and absolute basis, outperforming the Bloomberg Barclays U.S. Mortgage-Backed Securities (MBS) Index (the "Index") by 102 basis points (Class I shares net of fees; one basis point = 0.01%). The Fund's largest contributors over the quarter were its credit-oriented securitized positions as credit spreads tightened with improving fundamental credit conditions. The top performers were its allocations in U.S. non-agency residential mortgage-backed securities (RMBS), U.S. non-agency commercial mortgage-backed securities (CMBS) and U.S. asset-backed securities (ABS), specifically U.S. residential-related and aircraft ABS. The Fund's allocation to U.S. agency MBS was also a large contributor during the quarter both on a relative and absolute basis. The Fund's U.S. agency pass-through positions outperformed the Index during the quarter due to our overweight to lower coupon MBS (30-year 2.0% and 30-year 2.5%), which offer substantially higher carry than higher coupon MBS and benefited from the rally in rates and flattening curve. The portfolio's agency specified pool and collateralized mortgage obligation (CMO) positions also outperformed the Index. The Fund's duration positioning also added to performance during the period on an absolute basis, but on a relative basis the Fund's underweight to duration detracted from performance versus the Index as interest rates fell during the quarter.

Market Review

After the sharp rise in interest rates during the first quarter, the second quarter saw rates fall and spreads tighten slightly for credit-oriented securitized sectors. Despite a lot of noise in the economic data, the U.S. economic outlook remains very positive, supported by tailwinds of enormous fiscal spending, extraordinarily easy central bank policies and an improving pandemic outlook with the majority of the U.S. adult population now at least partially vaccinated. The European outlook is also improving as European vaccination rates are gradually catching up to U.S. and U.K. vaccination rates.

Securitized credit spreads were slightly tighter to unchanged during the second quarter. Most AAA securitized credit spreads have now fully recovered to pre-pandemic levels, although we believe these securitized credit sectors still offer attractive value relative to agency MBS or corporate credit securities. Housing and consumer sectors have continued to perform relatively better than other sectors, as home prices are up more than 15% over the past year[2] and as household savings rates hit record levels during the pandemic. RMBS and ABS delinquency and default levels remain relatively light. Within CMBS, office buildings, multi-family housing and industrial properties have also performed relatively better, while hotels and shopping centers have experienced greater economic stress. We have become more constructive on credit conditions overall as the pandemic impacts lessen and more sectors of the economy reopen.

1 Source: Morgan Stanley Investment Management Limited. Data as of June 30, 2021.
2 Source: S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index. Data as of June 30, 2021.

U.S. interest rates declined and the U.S. Treasury curve flattened during the quarter, with the 2-year U.S. Treasury rate increasing 9 basis points to 0.25%, while the 10-year U.S. Treasury rate decreased 27 basis points to 1.47%.[3] The Federal Reserve (Fed) purchased roughly $350 billion agency MBS during the second quarter, down from nearly $400 billion in purchases in the first quarter of 2021. The Fed has now purchased almost $2.2 trillion agency MBS since March 2020. Additionally, U.S. commercial banks have increased their agency MBS holdings by $244 billion in 2021, although the pace of bank purchases has slowed in recent months.[4] Thirty-year mortgage rates decreased along with Treasury rates, falling from 3.18% to 3.02% as of quarter-end.[5] MBS current coupon nominal spreads tightened 5 basis points during the quarter to 65 basis points above interpolated U.S. Treasuries.[3] The Bloomberg Barclays U.S. MBS Index returned 0.33%, underperforming U.S. Treasuries on a duration-adjusted basis by 62 basis points during the quarter.[3] The duration of the Bloomberg Barclays U.S. MBS Index was essentially unchanged at 4.2 years, despite the rally in rates during the quarter.[3] Although U.S. mortgage mutual funds saw net outflows during the quarter, thus far in 2021 they've seen net inflows of $2.5 billion.[3]

U.S. non-agency RMBS spreads were essentially unchanged in the quarter, with AAA spreads trading around 75 to 85 basis points, and BBB spreads ranging from 150 to 180 bps.[6] Mortgage fundamental performance continues to be generally positive as loan delinquencies and forbearance requests continue to decline and economic forecasts have shifted positively. National home prices increased more than 15% over the past year, fueled by record low mortgage rates and historically low housing supply.[2] New non-agency RMBS securitizations had a busy quarter, led primarily by securitizations of Prime Jumbo loans.

U.S. ABS spreads were generally tighter in the second quarter, although the extent to which varied significantly depending on rating and sector. AAA spreads tightened roughly 10 basis points and are trading roughly 40 to 60 basis points above comparable duration swaps for most credit card and auto deals.[7] BBB spreads were tighter, now ranging from 100 to 125 basis points.[7] Fundamental performance for consumer credit sectors continues to be solid. Delinquencies have been in line with historical vintage, with no substantial increases resulting from the pandemic. Used car prices have surged over the past few months, due to a lack of supply, providing additional collateral support for auto ABS securitizations. Personal income increased slightly during the quarter but remains materially higher year-to-date.[3] Personal consumption also rose during the second quarter and remains materially higher year-to-date.[3] Personal savings rates continue to be at record levels over the past year, and as a result, household balance sheets are at the best levels in decades.[3] ABS issuance remained healthy during the quarter, but issuance was met with equally strong demand.

U.S. CMBS spreads were slightly tighter over the quarter with AAA CMBS spreads roughly 10 basis points tighter, trading around 70 to 100 basis points above comparable duration swaps, depending on underlying collateral and duration.[8] CMBS issuance during the quarter increased, but still remains light versus historical levels. Recent issuance continues to be comprised of primarily larger single-asset CMBS securitizations rather than conduit deals composed of many smaller loans.

European RMBS spreads tightened slightly during the quarter as both new issuance and secondary trading volumes remain very low. The European Central Bank (ECB) kept its ABS holdings essentially unchanged at €28 billion during the quarter.[9] Fundamental performance remains solid, with only minimal increases in mortgage delinquencies. European RMBS, ABS and CMBS issuance was very light during the quarter, with only a handful of new securitizations coming to the market.

Portfolio Activity

We decreased our agency MBS positioning slightly as we have become increasingly negative on agency MBS, as spreads have continued to tighten and as the risks of the Fed tapering its MBS purchases have increased. During the quarter we increased our U.S. non-agency RMBS exposure from 32% to 34% as we continue to favor this sector due to the solid fundamentals of the U.S. housing market. Our ABS exposure fell from 19% to 17% during the quarter, and we increased our U.S. non-agency CMBS allocation from 5% to 7%.

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2 Source: S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index. Data as of June 30, 2021.
3 Source: Bloomberg L.P. Data as of June 30, 2021.
4 Source: Federal Reserve Bank of New York. Data as of June 30, 2021.
5 Source: Freddie Mac Survey Rate. Data as of June 30, 2021.
6 Source: Wells Fargo. Data as of June 30, 2021.
7 Source: J.P. Morgan. Data as of June 30, 2021.
8 Source: Bank of America. Data as of June 30, 2021.
9 Source: European Central Bank. Data as of June 30, 2021.

Strategy and Outlook

2021 is off to a solid start in the securitized credit markets, where a combination of spread tightening and cash flow carry have effectively counterbalanced the sharp rise in interest rates this year. Credit fundamentals remain strong in the residential and consumer sectors of the securitized markets, while commercial real estate continues to face some remaining pandemic-induced stress. We continue to have a positive outlook on residential and consumer credit sectors and a more cautious view on CMBS.

Agency MBS spreads remain at historically tight levels, and the primary buyers over the past year, the Fed and U.S. commercial banks, may begin to reduce their purchases in the coming months. To-be-announced (TBA) rolls for current coupon MBS, the coupons that the Fed is buying, offer the best value within agency MBS, in our view, as these coupons still offer attractive roll-adjusted carry. We remain underweight agency MBS as we think it looks expensive on both a historical and risk-adjusted basis.

Although U.S. non-agency RMBS have largely recovered to pre-pandemic levels, this sector presents the most attractive risk-adjusted opportunities within securitized markets. The fundamental U.S. housing market outlook looks solid as home prices are up 15% over the past year,[2] driven by affordability from historically low mortgage rates, low housing supply and increasing demand from both the millennial generation (the largest U.S. demographic cohort in history) and evolving work-from-home dynamics. Additionally, loan underwriting standards remain conservative, given memories of the Global Financial Crisis, so delinquency and default levels continue to be low, and securitization structures continue to provide very robust levels of structural credit protection. We remain overweight non-agency RMBS, and we believe spreads continue to look compelling versus comparably rated U.S. corporates or versus agency MBS.

For CMBS, we remain underweight overall with diverging views by sector. Valuations remain very idiosyncratic, with some attractive value opportunities and some potential credit problems as well. Commercial real estate continues to be the securitized sector most severely impacted by the pandemic. Shopping centers and business-oriented hotels remain under stress as business volumes are still substantially lower and these sectors appear less likely to fully recover, even in a post-pandemic world. Multi-family apartment buildings and office buildings have performed better and have lower risks of near-term defaults; however, these sectors have some uncertainties in the post-pandemic world, given the new work-from-home dynamic and the suburban flight, but the impact on these sectors appears to be less severe. Logistics centers and warehouse spaces are the one bright spot in CMBS, benefiting from the sharp rise in e-commerce.

For ABS, we also remain underweight overall with views differing by sector. Consumer sectors look very strong from a fundamental credit perspective, as savings rates and household balance sheets soared during the past 18 months. Additionally, unprecedented fiscal stimulus has provided a further safety net for lower income borrowers. Delinquency rates in auto loans, credit cards and unsecured consumer loans remain very low, but spreads in these sectors look expensive on a relative value basis. More attractive opportunities exist in the more pandemic-battered sectors of aircraft ABS and small business loans.

European markets are experiencing similar sector-specific performance dynamics, and overall European credit performance has been comparable to U.S. markets. European spreads appear slightly tight relative to comparable U.S. securitized assets. European securitized markets are likely to remain well supported by the historically low rates in Europe and by the asset purchase programs and lending programs of the ECB and Bank of England. We may reduce our European holdings in the coming months, in favor of U.S. securities, if current valuations remain in place.

Overall, we believe the securitized market offers a unique combination of low duration, attractive yields and solid credit fundamentals. We remain constructive on securitized credit and have a modest credit overweight across our portfolios. We remain cautious on interest rate risk, and we continue to manage the portfolios with relatively short durations.

FUND FACTS

Launch date	Base currency	Index
July 28, 1997	U.S. dollars	Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index

[2] Source: S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index. Data as of June 30, 2021.

Performance (%)

As of June 30, 2021 (Class I Share at NAV)

	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR	SINCE INCEPTION
MS Mortgage Securities Trust - I Shares	0.10	1.35	1.10	5.59	4.31	4.53	4.88	4.71
Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index	-0.04	0.33	-0.77	-0.42	3.78	2.27	2.64	4.66

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 0.91% for Class I shares and the net expense ratio is 0.70%. 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 fund has received proceeds related to certain non-recurring litigation settlements. If these monies were not received, any period returns which include these settlement monies would have been lower. These were one-time settlements, and as a result, the impact on the net asset value and consequently the performance will not likely be repeated in the future. Please visit www.morganstanley.com/im for additional details.

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. 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 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 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. 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. **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. **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. 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 strategy could sustain a loss. **High yield securities ("junk bonds")** are lower rated securities that may have a higher degree of credit and liquidity risk. **Foreign securities** are subject to currency, political, economic and market risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). **Inverse floaters** are sensitive to early prepayment risk and interest rate changes and are more volatile than most other fixed-income securities.

INDEX INFORMATION

The **Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index:** tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index measures U.S. residential real estate prices, tracking changes in the value of residential real estate nationally.

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.

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