

Morgan Stanley Funds (UK)

Sustainable Fixed Income Opportunities Fund

BROAD MARKETS FIXED INCOME TEAM

Performance Review

In the one month period ending 31 October 2024, the Fund's I ACC shares returned -0.70% (net of fees)¹.

The Fund had negative absolute performance in October.

During the month, macro decisions detracted from absolute performance while the Fund's positioning within spread sectors contributed.

Regarding macro decisions, duration positions in the U.S. and the euro area were the largest detractors from performance as global government bond yields rose over the month. Emerging markets exposure, particularly Peru, also detracted from performance.

Higher "risk-free" rates benefited performance in October.

The allocation to European spreads added to performance as spreads tightened over the period, particularly in Italy, France and Greece.

Exposure to both external and quasi spreads contributed to performance on the back of tightening spreads.

Within currency positions, the long Australian dollar and U.S. dollar vs. short Canadian dollar position detracted slightly.

Exposure to both investment grade corporate and high yield corporate bonds added to performance as spreads tightened during the period.

The allocation to securitised assets added to performance, specifically exposure to non-agency residential mortgage-backed securities (RMBS), non-agency commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS).

Market Review

Developed market bond yields rose in October as economic data came in better than expected. The September jobs report, released in early October, showed that the U.S. economy added 254,000 jobs during the month, with broad-based gains across sectors, and the unemployment rate fell to 4.1%.² Concerns about material weakness in the labour market thus began to ease. Likewise, the September inflation report was stronger than expected, though investors were encouraged by the moderation in the shelter-related components – in particular owners' equivalent rents.

As the U.S. presidential election drew nearer, markets also began to weigh the potential outcomes and their implications for the global economy and asset prices. The U.S. dollar surged as markets considered the outlook for global trade, while volatility increased in currencies such as the Chinese renminbi. Longer-maturity yields also rose as investors reassessed the fiscal outlook and its impact on bond markets. Meanwhile, outside the U.S., inflation data surprised to the upside in Europe, while activity data and purchasing manager's indexes (PMIs) pointed to a more resilient economic backdrop.

On foreign exchange markets, the U.S. dollar appreciated against major currencies, reversing its previous weakness, as interest rate differentials widened between the U.S. and the rest of the world. The rate-sensitive Japanese yen weakened 6% against the dollar³ despite promising news flow on the coming round of wage negotiations, while the New Zealand dollar also underperformed as the Reserve Bank of New Zealand delivered a 50 basis point rate cut and turned dovish given the weak local economic outlook. The euro was the most resilient G10 currency. We remain positive on the Australian dollar against the Canadian dollar given favourable economic fundamentals.

Portfolio Activity

Overall, the duration of the Fund was decreased by -0.34 years, closing at 2.84 years.

Regarding macro positioning, the Fund reduced duration exposure to Canada and the U.K., whilst increasing duration exposure to the U.S. and New Zealand. The Fund also initiated a short duration position to Japan.

Within spread sectors, the Fund marginally increased exposure to investment grade corporate and high yield corporate bonds as spreads tightened. The Fund also trimmed exposure to non-agency RMBS.

The Fund has an exposure to green bonds and social, sustainability and sustainability-linked bonds of 30.0%.

¹ Source: Morgan Stanley Investment Management Limited. Data as of 31 October 2024.

² Source: U.S. Bureau of Labor Statistics.

³ Source: Bloomberg L.P. Data as of 31 October 2024.

Strategy and Outlook

After showing consistent strength through the summer, bond market performance turned distinctly negative in October. The 10-year U.S. Treasury yield rose approximately 50 basis points (bps), generating the worst monthly bond market performance since the third quarter of 2022.³ This pushed year-to-date returns below that of cash and most other sectors outside of high yield and loans. This was especially unusual considering it occurred on the back of the Federal Reserve's (Fed) 50-bp rate cut. This rollercoaster-like performance is likely to continue as the doors open to even more macroeconomic, policy and rate volatility due to the surprisingly strong victory of Donald Trump and the Republican party in the recent U.S. election.

After the summer's run of weaker-than-expected U.S. labour market reports pushed the Fed toward cutting rates by 50 bps, labour market data for August and September rebounded with the unemployment rate falling from 4.3% to 4.1%.² Moreover, data on the real economy continued to power ahead. Gross domestic product (GDP) grew at an annualised rate of nearly 3% in the third quarter,⁴ and fourth quarter growth is forecast to be in the neighbourhood of 2.5%. Although there is no doubt that hiring has slowed, it has not collapsed, and the weakness can be explained by the usual ebbs and flows in hiring patterns along with concerns over the results of the presidential election. Rather than demand weakness alone, increased labour supply has driven unemployment higher over the past year. Going forward, we expect to see more stability and less deterioration in employment, suggesting the Fed would not need to aggressively cut interest rates over the next 12 months. We believe two more rate cuts are reasonable for 2024, taking the ceiling on the fed funds rate to 4.5%.

That said, there is now a heavy focus on the implications of the November U.S. elections. The market's immediate reaction on Wednesday, 6 November was clear. The results were: great for stocks; especially great for financial stocks; good for credit; terrible for U.S. Treasury bonds; not so good for the rest of the world's bonds; good for the U.S. dollar. This movement in asset prices seems logical given Trump and the Republicans' platform and policy preferences. Questions surrounding how markets will shift under policy and economic changes linger. One question is: how much dismantling of the Inflation Reduction Act and CHIPS and Science Act will occur? These policies have been strongly positive for the U.S. economy, and if the Republicans end these programmes without replacement, fiscal policy may be less expansionary than expected, putting less pressure on inflation and the Fed.

There is no doubt that the Republicans' sweeping victory in the November election has further changed the calculus of where bond markets are headed. Even before the election it was becoming less clear how much easing the Fed would do given the surprising strength in the U.S. economy. This is particularly true as recent Fed rate cuts were more in line with a recalibration of the rate structure than a move to counter concerns about imminent economic weakness. The need for this proactive stance, already being questioned prior to the election, is even more open to debate post election.

The election has given the forthcoming Trump administration, along with a likely Republican-controlled Congress (as House leadership was still undecided but strongly leaning Republican at the time of writing), considerable leeway to adopt large swathes of the Trump agenda as stated in policy proposals and campaign rhetoric. How much of this is actually implementable is an open question. It will be months before some clarity emerges, depending on staffing, prioritization of policies, etc. In the interim, the market will rely on the agenda as we currently understand it: tax cuts (both new and continuation of the 2017 cuts), tariffs (and potential trade wars), deregulation, and immigration (reduction thereof as well as possible heightened deportations). Markets will be awaiting more details on the new administration's legislative and executive order priorities and the timing and implementation of these policies to gain more confidence about the trajectory of inflation and growth.

The market's initial reaction to price out another rate cut in 2025 was reasonable, in our view, but how much more needs to be priced out remains to be seen. The implications for the rest of the world's central banks are more ambiguous. The initial reaction on 6 November was bullish: the Trump agenda was expected to be good for U.S. growth/inflation but bad for growth elsewhere, meaning central banks outside the U.S. would step up their easing in response, which led to a distinct steepening of yield curves. Although we are sympathetic to this reaction, we are not sure it is entirely correct. A stronger U.S. dollar, higher tariffs and less efficient allocation of resources are inherently inflationary for the U.S. economy. The growth impact to the U.S. is probably negative. The questions are: which comes first and which is viewed as worse from a monetary policy perspective? This will likely complicate the rate-cutting paths of central banks around the world. We have already seen the Norwegian and Indonesian central banks postpone cutting interest rates due to currency weakness (albeit not directly related to Republican electoral success).

In terms of impacts on bond yields, we can expect the following: further upward pressure on yields, steeper yield curves due to inflationary pressures and rising risk premiums. We believe the new floor on the 10-year U.S. Treasury yield is likely to be 4%, with a ceiling of 5%, the 2023 high.

Credit markets were performing well before the election, and they have performed even better in the days following. This initial response makes sense as a stronger U.S. economy leads to improved cash flows and deregulation and protectionism help U.S. profits (at least in aggregate). However, the longer-term impact is less obvious. Greater opportunities and more regulatory leeway usually lead to riskier behaviour and greater leverage — not usually positive for creditors. With credit spreads on the tight side (expensive by historical standards but not overvalued), opportunities remain attractive, but we do not expect especially high returns.

Our credit market strategy is focused on avoiding problematic companies and building as much yield into the portfolio without taking undue risks. There is little reason to believe spreads will materially widen when economic growth is decent and central banks

² Source: U.S. Bureau of Labor Statistics.

³ Source: Bloomberg L.P. Data as of 31 October 2024.

⁴ Source: U.S. Bureau of Economic Analysis. Data as of 30 October 2024.

are predisposed to cutting interest rates. Yield-oriented buying should contain spread widening. We remain modestly overweight credit in our portfolios with a modest bias to higher quality.

Emerging market (EM) bonds are unlikely to thrive under a Trump-led Republican government. Stronger growth but higher rates and weaker global trade linkages are not usually conducive to strong EM performance. That said, we believe countries with solid economic outlooks, decent growth, falling inflation and a central bank able and willing to cut interest rates despite policy changes in the U.S. are likely to perform well. Country and security selection remain imperative. We continue to avoid Mexican and Brazilian bonds as their respective markets deal with political uncertainty (Mexico), fiscal risks (Brazil) and Trump policies.

With all the noise and uncertainty now coming out of Washington, we believe the most attractive opportunities remain in securitized credit, particularly in U.S. mortgage-backed securities. U.S. households with prime credit ratings have strong balance sheets, which should continue to be supportive of consumer credit and ancillary structures, especially as housing prices remain firm. Changes in U.S. tax policy should also be supportive. Higher coupon U.S. agency mortgage securities remain relatively attractive versus investment grade corporates, and we believe they are likely to outperform U.S. Treasury bonds. As in our corporate credit positioning, we are looking to move our securitized credit exposures up in credit quality and out of non-U.S. structures given tighter spreads and increased macroeconomic risks in Europe. One area in securitized credit that is vulnerable to a potentially changing Fed policy is commercial mortgage-backed securities (CMBS). If interest rates do not fall as much as expected, the refinancing of many U.S. office-backed deals will become problematic. We continue to generally steer clear of this sector.

In currency markets, the outlook for the U.S. dollar has improved since Trump's election. Easier fiscal policy, tighter monetary policy (relative to previous expectations), trade wars and stronger U.S. growth all bode well. However, one caveat to this upbeat narrative is surprisingly weak U.S. employment. Further deterioration will give the Fed room to continue to cut interest rates as long as the Trump agenda does not upset the inflation story. The U.S. economy remains exceptional with regard to its growth trajectory, productivity performance, profit performance and level of yields. It is a high hurdle for other currencies to beat these fundamentals.

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

Fund Facts

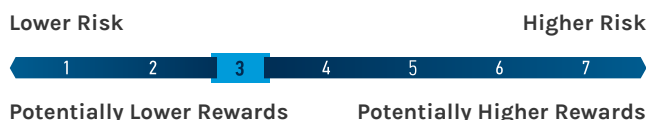
Launch date	11 December 2020
Base currency	Sterling

12 Month Performance Periods to Latest Month End (%)

	OCTOBER '23 - OCTOBER '24	OCTOBER '22 - OCTOBER '23	OCTOBER '21 - OCTOBER '22	OCTOBER '20 - OCTOBER '21	OCTOBER '19 - OCTOBER '20
OEIC Sustainable Fixed Income Opportunities Fund - I					
ACC Shares	9.15	3.85	-10.18	--	--

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.**

Share Class I ACC Risk and Reward Profile



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 interest securities, and the fund's simulated and/or realised return has experienced medium 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 can be complex and volatile, 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.
- Sustainability factors can pose risks to investments, for example: impact asset values and increased operational costs.
- There may be an insufficient number of buyers or sellers which may affect the fund's ability to buy or sell securities.
- Investment in China A-Shares via Shanghai-Hong Kong Stock Connect program may also entail additional risks, such as risks linked to the ownership of shares.
- There are increased risks of investing in emerging markets as political, legal and operational systems may be less developed than in developed markets.
- 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 October 2024 and subject to change daily.

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