Morgan Stanley Investment Funds

Global Bond Fund

BROAD MARKETS FIXED INCOME TEAM

Performance Review

In the one month period ending 30 September 2024, the Fund's I shares returned 1.61% (net of fees)[1], while the benchmark returned 1.70%.

The portfolio's macro decisions detracted from performance while positioning within spread sectors contributed.

Regarding macro decisions, the yield curve steepening position in the euro area added to performance, along with the overweight to Canadian rates. Outperformance was offset by the underweights to U.S. rates and the exposure in emerging markets (EM) rates.

The underweight to Italian spreads detracted from performance as spreads tightened during the period. The overweight to quasi-government spreads added to performance as spreads tightened. Exposure to Japanese inflation breakevens detracted from performance as breakeven spreads tightened in September.

Positioning within investment grade corporate bonds had a small negative impact on performance.

Within securitized assets, the overweight allocation added to performance, especially the long exposure to agency/non-agency residential mortgage-backed securities (RMBS) and non-commercial mortgage-backed securities (CMBS).

Market Review

September was a month of two halves for fixed income markets. First, bond yields fell as investors began to price in more aggressive rate cuts by the U.S. Federal Reserve (Fed), including a greater likelihood of a 50-basis point cut at the September meeting. This was despite activity data coming mostly in line with expectations, and the August Consumer Price Index release showing signs of a rebound in shelter inflation, although the labour market report did confirm previous indications of slowing. At its September meeting, the Fed delivered a 50-basis point cut and underscored its commitment to averting further weakness in employment. At the same time, it maintained its optimistic view on the current labour market and estimates of the policy rate in the longer term – as reflected in the Summary of Economic Projections – shifted higher, leading to a steepening of the yield curve. Longer maturity bond yields also rose in the latter half of September, as economic data including jobless claims came in stronger than expected. Outside the U.S., eurozone economic data showed further signs of deterioration. Purchasing mangers' indexes (PMIs) for both manufacturing and services came in materially below expectations, while inflation data was also weaker than expected. Governing Council members including European Central Bank (ECB) President Christine Lagarde acknowledged that disinflation was taking place faster than anticipated. This led to the market pricing that the ECB would cut interest rates more quickly than at the quarterly pace of cuts expected previously.

Portfolio Activity

Overall, the underweight duration of the portfolio was decreased by 0.04 years, closing at -0.13 years.

Regarding macro positioning, the Fund reduced the underweight to U.S. and overweight to U.K. We initiated a small overweight to Denmark and the euro area, and closed the small overweight to Uruguay.

Within spread sectors, the Fund trimmed the underweight to agency/non-agency RMBS and CMBS. The Fund marginally increased the underweight to investment grade corporates, by trimming some of the financial and industrial names where spreads looked tight. We added to the covered bond exposure.

Strategy and Outlook

Bonds continued their stellar run in September. Yields fell across most government bond markets while credit spreads modestly tightened. Unlike in August, non-U.S. Treasury markets led the way in September as yields fell double digits except in the U.K. and Japan. Economic data continued to be worrisome, particularly the growth outlook in Europe and with the U.S. labour market in the spotlight after a very weak July number. The good news is that the U.S. labour market did not worsen in August, but it also did not improve much, keeping markets concerned about the deteriorating trend. There is historical evidence that once the unemployment rate rises, like it has, it continues to worsen until Federal Reserve (Fed) monetary policy or other fiscal policy measures are implemented. While we do think there are extenuating circumstances this time around suggesting the current level of the unemployment rate is not cause for concern, the Fed — as the world's most important risk manager — should take notice.

And it did. The big news that really propelled markets higher was the Fed's decision to cut interest rates 50 basis points (bps) and raise its forecast to another 50 bps of rate cuts this year — a large turnaround from June when officials anticipated only cutting rates once in 2024, by 25 bps. The market had been expecting a smaller cut with the decision emphasizing the Fed's worries that, with inflation falling and the unemployment rate rising, policy rates were too restrictive. The European Central Bank also cut rates, highlighting improving inflation and a weak growth outlook.

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[1] Source: Morgan Stanley Investment Management Limited. Data as of 30 September 2024.

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The Fed's move is significant. It represents a commitment to be pre-emptive in reducing restrictiveness before the economy weakens or unemployment moves much above normal. With the U.S. economy increasingly appearing near its long-term growth and inflation (target) trends, it is no longer necessary to keep policy so tight. In other words, if the economy is performing "normally", then shouldn't interest rates be "normal" too? Thus, the Fed has begun to recalibrate monetary policy. The big question is how much recalibration is necessary. The market is looking for substantial rate cuts both this year and next, taking the fed funds rate down to 3% by early 2026. This is an aggressive forecast. With U.S. inflation above target and gross domestic product growth strong, it is not clear how much policy rates need to be cut. We believe taking rates down by 100 bps is fairly easy, as monetary policy is still tight even at a 4.5% policy rate. For the Fed to go below 4%, it will need more evidence that labour markets will likely deteriorate further or inflation is falling to target quickly. While possible, this is not our base scenario.

With U.S. Treasury yields hovering around 3.8% (interestingly, about the same level where we started the year), it will be difficult for yields to fall further even with 100 bps of rate cuts this year, unless the data unexpectedly weakens further (i.e., the unemployment rate going above 4.4%, the peak in the Fed's forecast). With rate cuts largely discounted by the market it is difficult to forecast further drops in yields. On the other hand, the trend in U.S. employment has been weaker, so it is also difficult to oppose the third quarter bull market. As always, markets and policy will be data-dependent, which unfortunately are likely to be volatile in the months ahead. A neutral-ish to slightly underweight duration position in the U.S. looks appropriate, in our view, with better value outside the U.S. — whether in Europe, where economic growth is anaemic and central banks are responding, or in Asia, where countries like New Zealand are behind in the rate-cutting cycle but are experiencing weaker growth. In the longer term, where U.S. and global 10-year yields go to depends on the extent of the easing cycle.

Credit markets (let alone equities) also continued to perform. A combination of strong nominal and real U.S. growth combined with falling inflation, easier monetary policy and evidence of strong productivity growth provides an exceptionally good backdrop. That said, credit spreads, for both investment grade and high yield, are struggling to move lower. Both are at the tight end of their historical ranges (euro investment grade looks better) and will be challenged to meaningfully tighten further. U.S. spreads could tighten a bit further, but that will probably be it. In both cases, markets are punishing underperformers, making company/sector selection increasingly important. Indeed, as credit spreads most likely move sideways over the fourth quarter, security selection will be increasingly important as any underperformance from owning underperforming companies will be difficult to offset with winners.

The appropriate credit market strategy should be focused on avoiding problematic companies and building in as much yield as possible without taking undue risks. There is little reason to believe spreads will materially widen when economic growth is decent (and coming in around expectations) and central banks are cutting rates, potentially aggressively. Yield-oriented buying should contain spread widening, but any slackening in demand could be problematic, although there is no evidence of this from September when there was record issuance and spreads tightened, albeit modestly. This risk is offset, however, by central banks' rate-cutting bias, which should serve to truncate spread widening risk, as it reduces tail risks of recession.

Emerging market (EM) local debt market returns were also solid in September with several countries performing quite well. If a country has a solid economic outlook, decent growth, falling inflation and a central bank able and willing to cut rates, we believe bonds are likely to perform well. But, as with corporate credit, when bad news arrives or markets are disappointed, bonds and currencies can be hit badly. Choosing exposures wisely remains very important. We continue to avoid Mexican and Brazilian bonds as their respective markets deal with political uncertainty (Mexico) and fiscal risks (Brazil). We remain focused on idiosyncratic opportunities that feature favourable risk/reward characteristics such as in the Dominican Republic, Colombia and Peru.

The most attractive opportunities remain in U.S. mortgage-backed securities and other securitized credit given ongoing uncertainty about the state of the U.S. economy and the Fed's likely reaction function. U.S. households with prime credit ratings have strong balance sheets, and this should continue to be supportive of consumer credit and ancillary structures, especially as house prices remain firm. U.S. agency mortgage securities still have value compared to investment grade credit, at least in higher coupons, and we believe they are likely to outperform U.S. Treasury bonds, although their third quarter outperformance has diminished our enthusiasm.

In currency markets, the outlook for the U.S. dollar remains unclear. It has weakened as U.S. interest rates have fallen relative to the rest of the world, but we are not as optimistic about the likely extent of rate cuts. However, it is possible the Fed's employment mandate will incentivize the Fed to be equally or even more dovish than other central banks that have weaker economies. The U.S. economy, even with a slowdown, is still growing faster than most other countries, implying that rate cuts in the U.S. could eventually bolster the U.S. economy and currency. As of now, however, it remains unclear who can surpass the U.S. as global growth leader. Europe and China are seeing lacklustre cyclical data in addition to grappling with structural woes — although the Chinese stimulus programs announced in September have significantly boosted Chinese stocks, possibly bolstering the currency at least in the near term. Despite faster growth in general, emerging markets continue to be confronted with idiosyncratic challenges (as well as opportunities). Emerging market currencies continue to be positively affected by easier U.S. monetary policy but remain subject to a variety of local risks that may or may not overcome the risk-on bias of G7 central bank easing (along with Chinese stimulus). We look to capitalize on idiosyncratic mispricings where there are clear fundamental and value differences. For now, the dollar is likely to remain under pressure.

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

Fund Facts

Launch date	01 November 1989
Base currency	U.S. dollars
Benchmark	Custom- Blended Benchmark

Calendar Year Returns (%)

Past performance is not a reliable indicator of future results.

	YTD	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014
Class I Shares	3.98	5.90	-16.73	-5.10	10.48	8.79	-2.63	9.57	2.37	-4.52	2.05
Blended Benchmark	3.60	5.72	-16.25	-4.71	9.20	6.84	-1.20	7.39	2.09	-3.15	0.59

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 Risk and Reward Profile

- The fund may be impacted by movements in the exchange rates between the fund's currency and the currencies of the fund's investments.
- The value of bonds are likely to decrease if interest rates rise and vice versa.
- The value of financial derivative instruments are highly sensitive 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, increased operational costs.
- There may be an insufficient number of buyers or sellers which may affect the funds ability to buy or sell securities.
- Investment in Fixed Income Securities via the China Interbank Bond Market may also entail additional risks, such as counterparty and liquidity risk.
- 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 30 September 2024 and subject to change daily.

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The **Bloomberg Global Aggregate Index**: provides a broad-based measure of the global investment grade fixed-rate debt markets. Total Returns shown is unhedged USD.The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

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The **FTSE WGBI Index:** measures the performance of fixed-rate, local currency, and investment grade sovereign bonds. The WGBI provides a broad benchmark for the global sovereign fixed income market.

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