Morgan Stanley Investment Funds

European Fixed Income Opportunities Fund

BROAD MARKETS FIXED INCOME TEAM

Performance Review

In the one month period up until 31 May 2024, the Fund's Z shares returned 0.58% (net of fees)[1].

Overall, duration positioning had a positive impact on the Fund's performance.

The Fund's positioning in developed markets rates (U.S. dollar) had a small positive impact on performance as yields fell across the curve.

The contribution from emerging markets (EM) local rates was negligible.

Within euro area spreads, the allocation to Italian BTPs detracted from performance as spreads tightened.

The allocation to investment grade (preference for euro over U.S. dollar credit, with a bias to financials, focused on significantly important institutions) and high yield corporates both contributed given tighter spreads in the U.S. and Europe.

The allocation to government-related bonds added to performance.

The allocation to EM external debt had a positive impact on performance.

Portfolio Activity

The Fund has 1.40 years of interest rate duration.

During the month, the portfolio's duration was reduced by -0.13 years.

The allocation to investment grade corporates was increased, primarily within industrials.

Strategy and Outlook

Market Review and Outlook

May was a month of two halves in the developed markets rates markets. Bond markets rallied in the first half of the month as the Federal Reserve (Fed) leaned dovish at its May meeting, continuing to signal an intention to cut interest rates. Economic data, such as U.S. retail sales, also came in weaker than expected while the April U.S. consumer price index (CPI) print ended a string of upside inflation surprises, with services inflation in particular moderating. Later in the month, however, policymakers turned less dovish and data came in stronger. Various Fed speakers also began to explicitly reference further policy tightening, though they were quick to stress rate hikes were not in their base case, while minutes from the May meeting revealed that a few policymakers doubted just how restrictive current policy is. Inflation in other markets – most notably, Australia, the U.K. and the eurozone – was also higher than expected and showed signs of price pressures reaccelerating.

While several DM central banks are widely expected to cut rates in the coming months, the depth of the cutting cycle is more important for fixed income markets than the timing of the first cut. Recent data and policy communications suggest central banks will likely adopt a cautious approach. We have stayed short duration as momentum is bearish, carry is negative and valuations in longer maturities are unattractive, in our view. Cross-market, we prefer to be short Australian vs. U.S. rates due to evidence of still-sticky inflation and the Reserve Bank of Australia turning more hawkish. We also remain underweight duration in Japan, where communication has turned less dovish amid concern about the weak yen, and confidence has grown that positive wage-price dynamics will likely lead to sustainably higher inflation.

During the month, investment grade credit spreads continued to grind tighter, with euro spreads outperforming the U.S., and credit volatility remained low. Market sentiment was dominated by several factors: Firstly, inflation and growth data surprised to the upside in Europe but was in line with expectations in the U.S. Secondly, central bank policy continues to diverge as the European Central Bank (ECB) is expected to cut rates in June while the Fed remains hawkish. Thirdly, first quarter corporate reporting was positive for credit with the confirmation that corporates were seeing limited stress in their businesses with the majority running low risk strategies. Merger and acquisition (M&A) activity continues to be conservatively funded from a bondholder perspective. Finally, the technical remains strong as higher-than-expected supply is met with strong demand.

May was a modestly strong month for the U.S. and global high yield markets. The average yield in the U.S. high yield market fell by more than 35 basis points (bps) over the first two weeks of the month before gradually climbing in the second half as spreads modestly widened.[2] Ultimately, the average spread ended the month only slightly higher while the average yield was modestly lower on the back of lower U.S. Treasury yields. The technical conditions in high yield strengthened in May as retail demand was notably stronger, gross issuance increased and net issuance remained light, with capital markets squarely focused on refinancing.

[1] Source: Morgan Stanley Investment Management Limited. Data as of 31 May 2024.
[2] Source: ICE Data Indices. Data as of 31 May 2024.

Finally, traditional default activity among high yield bond issuers was non-existent in May; however, the volume of distressed exchanges remained elevated.

Looking forward, our base case remains constructive for credit, supported by expectations of an economic soft landing, low-risk corporate strategies, accommodative fiscal policy and positive momentum. Considering current credit spreads valuation, we see a market that is fairly priced, and hence we see carry as an attractive return opportunity. But, given the uncertain medium-term fundamental backdrop, we have less confidence in expected spread tightening. Our outlook for the high yield market is somewhat cautious as we progress through the second quarter. The high yield market is contending with several elements of uncertainty and the unique combination of historically attractive yields and an average spread that ranks near cycle lows.

U.S. agency mortgage-backed securities (MBS) spreads tightened 10 bps in May to 143 bps above comparable duration U.S. Treasury bonds, as demand remained very strong and new issue deals were consistently oversubscribed.[3] Agency MBS spreads are now 4 bps wider in 2024.[3]

Securitised credit sectors have been among the best performing sectors in 2024, but performance should normalise in the coming months. We still believe that current interest rate levels remain stressful for many borrowers and will continue to erode household balance sheets, causing stress for some consumer asset-backed securities (ABS). Commercial real estate also remains challenged by current financing rates. Residential mortgage credit opportunities remain our preferred sector. Our view on agency MBS valuations has moved from neutral to positive.

May performance was positive for the major segments of emerging markets debt (EMD). Global bond markets reacted positively to softer-than-expected U.S. inflation for April, and this helped support EMD assets as well. Most emerging markets currencies strengthened month-over-month and the U.S. dollar weakened. The Chilean peso rallied as copper, a major export for the country, continued the price rally that started in April. One notable outlier was the Philippine peso, which continued its year-to-date weakening streak as inflation remains sticky.

We believe valuations for EMD are still attractive and assets are cheap, which presents an attractive entry point for investors. With real yields near historically high levels and continued falling inflation, this provides a good environment for bond investors. The direction of monetary policy in the U.S. is likely easing, which can provide a supportive backdrop for emerging markets assets.

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

Fund Facts

Launch date	30 September 2014
Base currency	Euro

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 Z Shares	2.02	6.19	-7.86	-0.89	3.15	5.09	-3.64	4.62	2.06	0.48	--

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.**

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

Share Class Z 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 31 May 2024 and subject to change daily.

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INDEX INFORMATION

Inflation measured by the **consumer price index** (CPI) is defined as the change in the prices of a basket of goods and services that are typically purchased by specific groups of households with the G7 countries.

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