

Morgan Stanley Investment Funds

US Dollar Short Duration Bond Fund

BROAD MARKETS FIXED INCOME TEAM

Performance Review

In the one month period ending 30 April 2024, the Fund's Z shares returned 0.17% (net of fees)¹, while the benchmark returned 0.21%.

In April, the portfolio performed in line with the benchmark. The portfolio's curve positioning detracted from relative performance while the portfolio's exposure to investment grade financials and industrials contributed as spreads tightened.

Market Review

April was another challenging month for fixed income returns following higher-than-expected growth and inflation data from the United States. These higher prints caused markets to push back expectations for interest rate cuts in the U.S. and reduce the magnitude of cuts between now and the end of 2025. The shift in expectations was felt across the world as yields rose in both the developed and emerging markets. The U.S. dollar rose 1.7% over the month,² mainly due to these changes in expectations. Investment grade credit spreads were marginally tighter over the month, and U.S. high yield spreads widened 2 basis points (bps) while euro high yield spreads widened 16 bps.² Securitized credit spreads continued to outperform their corporate counterparts, with spreads broadly tightening over the month, while agency mortgage-backed securities (MBS) spreads widened.²

Portfolio Activity

In April, the portfolio reduced the exposure to investment grade financials and industrials.

Strategy and Outlook

April proved to be another disappointing month for fixed income. Markets were hit by three interrelated shocks, all centered on the U.S.: growth and inflation surprised to the upside and, as a consequence, the Federal Reserve (Fed) dialed back their confidence that rates would fall by their expected amount (75 bps according to the March dot plot). With U.S. inflation trending higher in the first four months of the year, and economic activity resilient, the Fed had no choice but to brace the markets for a slower-than-anticipated easing cycle. That said, the May Federal Open Market Committee (FOMC) meeting, particularly Chairman Powell's press conference, emphasized that in the committee's opinion, disinflation was forestalled. To drive the point home, Powell effectively dismissed the possibility of an impending rate hike, and this predilection has important investment implications.

First, the Fed wants to cut rates. If inflation had behaved in the first quarter, rates would have most likely been cut 25 bps in May. This provides support for shorter-maturity bonds while likely raising term premia on longer-dated bonds due to their willingness to risk higher inflation to keep the economy ticking along. Second, which is a corollary to the first, the Fed does not want a recession. The Fed believes inflation is falling (as it is on a year-over-year basis) and there is no need to rush the process with an overly tight policy stance. Third, if recession risks are once again further reduced, this opens the door to continued good performance in risky assets, such as credit and emerging markets. Fourth, if inflation does resume its disinflation path over the remainder of the year, we will likely have a bull market in rates. Fifth, if the Fed is wrong about inflation, meaning that it will not fall enough to cut rates — or worse, start trending higher — markets may experience déjà vu: a slimmed down repeat of 2022.

What is true for the U.S. is essentially true for most other countries. Inflation is the constraint on easier monetary policy. The good news is that inflationary pressures appear to be more muted outside of the U.S. The European Central Bank (ECB) and Bank of Canada are likely to ease in the second quarter, and Switzerland already eased. These moves are, however, already discounted by the market, with the only questions being how much and how often the central banks will cut. On this issue, not too dissimilar to the Fed, these central banks continue to be a bit coy by making further adjustments very data dependent.

What does this mean for bonds? Longer-maturity U.S. yields look about right for the current data set after their sharp sell-off in April, and a meaningful rally is constrained by the inverted yield curve: when 2-year yields rally, so can 10-year yields. It is interesting that current 10-year yields are very close to their average in the 2002-2006 period when economic growth was very similar to what it is today. Longer term, a real yield over 2% on a U.S. Treasury security looks like decent value, but don't expect a rally unless the economic growth situation deteriorates unexpectedly or inflation resumes its downward trajectory. On this latter point, it will be difficult for inflation to hit the Fed's forecast over the remainder of the year given its sharp underperformance over the first four months of the year.

Credit markets were remarkably well behaved in April, despite a mid-month wobble, and they also significantly outperformed equities. This strong performance despite historically tight spreads is a testament to the value they offer in this era of high nominal

¹ Source: Morgan Stanley Investment Management Limited. Data as of 30 April 2024.

² Source: Bloomberg L.P. Data as of 30 April 2024. One basis point = 0.01%

and real yields. While we do not expect further meaningful tightening, there is also no reason to believe that spreads will widen meaningfully given still sound fundamentals and macroeconomic performance that should be supportive of spreads. We believe strong yield-oriented buying should help prevent spreads from widening, and a neutral to modestly overweight credit position still seems warranted.

EM local markets also had a challenging April, although most managed to outperform U.S. Treasuries. Worries about U.S. inflation derailing the Fed undermined an otherwise nice story of falling inflation and central bank rate cuts. We do not think EM rate cutting is over. Instead, like in the U.S., the cycle may be elongating, but the starting point for yields is now more attractive. We also continue to favor Latin American local markets.

Given the uncertainty surrounding the robustness of the global economy, worries about U.S. inflation and likely central bank reactions to such data, we continue to find the most attractive fixed income opportunities in shorter-maturity securitized credit, such as residential mortgage-backed securities (RMBS), asset backed securities (ABS), and selective non-office commercial mortgage-backed securities (CMBS), given their higher yields and strong collateral. U.S. households with prime credit ratings have very strong balance sheets. This should continue to be supportive of consumer credit and ancillary structures, especially as house prices remain firm. Although they struggled in April, U.S. agency MBS still have value compared to investment grade credit, at least in higher coupons, and we believe they can outperform U.S. Treasuries.

In currency markets, the outlook for the U.S. dollar remains murky. The dollar is at a high valuation, but U.S. economic outperformance has been notable, as has been its high yields. Until the rest of the world's economies catch up, the dollar is unlikely to meaningfully fall. That said, a more benign inflation environment should be ideal for a resumption of the carry trade: buying higher yielding currencies and selling lower yielding ones, particularly in emerging markets. As such, we are not convinced that materially underweighting the dollar makes sense, but we are also not convinced one should be overweight the dollar. We continue to believe selective EM currencies look like better opportunities against the dollar, European and Asian currencies.

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

Fund Facts

Launch date	22 April 2016
Base currency	U.S. dollars
Benchmark	ICE BofAML 1-Year U.S. Treasury Note Index

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	1.37	5.90	-0.50	0.04	2.55	3.92	1.92	1.75	--	--	--
ICE BofAML 1-Year U.S. Treasury Note Index	1.04	4.74	-1.02	-0.07	1.82	2.93	1.86	0.57	--	--	--

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 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.
- 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 April 2024 and subject to change daily.

Applications for shares in the Fund should not be made

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INDEX INFORMATION

The **ICE BofAML 1-Year U.S. Treasury Note Index**: is an unmanaged index tracking U.S. government securities with a maturity of at least one year and less than three years.

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