Morgan Stanley Investment Funds

US Dollar Short Duration High Yield Bond Fund

HIGH YIELD TEAM

Performance Review

In the one month period ending 30 June 2024, the Fund's Z shares returned 0.95% (net of fees)[1], while the benchmark returned 0.90%.

The pharmaceuticals and health care sectors were the top-performing sectors relative to the benchmark in June. Relative outperformance in both sectors was driven by favorable credit selection. The top individual contributor in the pharmaceuticals sector was an overweight position in a manufacturer and distributor of pharmaceutical products and consumer health care goods. The company reported first quarter earnings at the end of May that showed improving operating results. Within the health care sector, an overweight position in a regional hospital operator was the top relative performer. The company continues to execute well, and its recently released second quarter earnings exceeded expectations.

The transportation services and construction machinery sectors were the worst-performing sectors relative to the benchmark during the month. Relative underperformance in transportation services was driven by challenging credit selection and an overweight position in the sector. The primary individual detriment in the sector was an overweight position in a car rental company. The company continued to struggle in June as it issued additional debt in an attempt to shore up its balance sheet. In addition, the company provided second quarter earnings estimates that were well below expectations. Relative underperformance in the construction machinery sector was driven by adverse credit selection and was led by an overweight position in a large integrated equipment dealership platform.

From a credit quality perspective, favorable credit selection and an overweight position in bonds rated CCC or below contributed positively to relative performance. An off-benchmark allocation to select convertible bonds also helped relative returns during the period. Conversely, challenging credit selection in BB-rated bonds hurt relative returns. Credit selection and an overweight position in B-rated bonds also detracted from relative performance in June.

Market Review

In June, performance in the high yield market was generally firm and led by the higher quality, longer-duration segments that benefited from a further decrease in Treasury yields. The drop in Treasury yields was partially offset by modestly higher average spreads. The pace of primary issuance slowed in June and demand moderated from May levels, though remained supportive. Bonds issued to take out loans continued to account for a large portion of refinancing volume in June as loan issuers looked to reduce interest cost. Secured bonds account for the majority of this type of issuance and have continued to drive the secured percentage of the high yield market to new record highs.[2] Meanwhile, the distressed segment of the high yield market continued to grow, while default activity remained low.

The Bloomberg U.S. Corporate High Yield Index returned 0.94% in June. The yield-to-worst finished the month 9 basis points (bps) lower at 7.91%. The spread-to-worst closed the period 6 bps higher at 333 bps.[3]

The top-performing sectors for the month were natural gas utility, other financial, and insurance, with respective returns of 1.47%, 1.39%, and 1.18%. The banking, transportation, and real estate investment trust (REIT) sectors were the worst-performing sectors in June, with respective returns of 0.41%, 0.57%, and 0.81%.[3]

The higher quality segments generally outperformed for the one-month period. The BB-rated segment returned 1.05%. Meanwhile, the single-B and CCC segments posted respective returns of 0.96% and 0.55%.[3]

The technical conditions in high yield remained strong in June. Inflows from retail investors remained positive and gross issuance volume slowed to the slowest pace of 2024. Gross issuance decreased 47% month-over-month to $17.9 billion of issuance in June, contributing to year-to-date gross issuance of $165.5 billion. By use of proceeds, refinancing accounted for 79% of June issuance, acquisition financing accounted for 10% and dividends for 6%. According to preliminary Lipper estimates, U.S. high yield retail funds recorded a net inflow of $1.4 billion in June, bringing the total year-to-date inflow to $5.5 billion.[4]

June marked the quietest month for default and distressed exchange activity since July 2023. According to J.P. Morgan, the high yield trailing 12-month par-weighted default rate including distressed exchanges decreased 23 bps from 2.02% to 1.79% in June, which marked a 17-month low. Excluding distressed exchanges, the rate ended June at 1.17%. The loan trailing 12-month par-weighted default rate including distressed exchanges decreased 19 bps to close the month at 3.10%.[4]

[1] Source: Morgan Stanley Investment Management Limited. Data as of 30 June 2024.
[2] Source: ICE Data Indices, Morgan Stanley Investment Management. Data as of 30 June 2024.
[3] Source: Bloomberg L.P., Morgan Stanley Investment Management. Data as of 30 June 2024.
[4] Source: J.P. Morgan. Data as of 1 July 2024.

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Strategy and Outlook

Our outlook for the high yield market remains somewhat cautious as we begin the third quarter. The high yield market is contending with increasing uncertainty and several likely sources of volatility over the intermediate term, with the ultimate question centering on the magnitude of the anticipated volatility. The key issues are central banks' evolving monetary policy, economic conditions, the labor market and consumer health, and ultimately, the health of the corporate fundamentals of high yield issuers. High yield faces this uncertainty with historically attractive all-in yields and an average spread that, when excluding the distressed segment of the market, is approaching all-time lows.[2] Further inspection of valuations reveals a market that has become increasingly bifurcated by both sector and credit quality.

In June, both the European Central Bank and the Bank of Canada lowered their key policy rates for the first time, after a multiyear campaign of policy tightening. Meanwhile, the Bank of England and the Federal Reserve (Fed) maintained their key policy rates, with the Fed's June Summary of Economic Projections guiding to one interest rate cut in 2024.[5] Chairman Powell did provide some concession at the May meeting in the form a $35 billion reduction in quantitative tightening. Recent data indicates progress in the fight to combat inflation, yet further progress is needed before the Fed's 2% target is reached. In June, the three-month annualized consumer price index (CPI) declined to nearly 2.5%, while the comparable reading for core CPI declined to just over 3%. However, year-over-year core CPI remains near 3.5%.[5] In the June press conference, Chairman Powell articulated that the Fed is sufficiently comfortable with realized inflation and inflation expectations that officials are comfortable placing increased emphasis on the labor market, should conditions materially weaken. We anticipate the Fed's reaction function to a marked shift in labor conditions to be forceful, should inflation remain at or below the current three-month annualized trend.

The resilience of the U.S. economy has thus far exceeded our expectations; however, there are now signs economic activity is moderating. In June, the Institute for Supply Management (ISM) Manufacturing Purchasing Managers' Index (PMI) decreased to 48.5, indicating a contraction in manufacturing activity, while the ISM Services PMI remained slightly in expansionary territory, modestly above 50.[6] We attribute this to both a weakening consumer that is spending a greater percentage of earnings on critical services, as well as the effects of a stronger dollar as consumers substitute lower-cost imports. Our expectations for slowing economic growth are further supported by the underlying trends in the labor market. The number of jobs per unemployed person has fallen from a peak of 2.0 to a current level of 1.25, the U3 unemployment rate has increased to 4%, and the U6 rate, which also captures the discouraged and underemployed, has recently increased to 7.4%.[7] Unsurprisingly, the quit rate is declining, reflecting workers' reduced confidence in their ability to find new jobs. These trends are balanced with the full understanding that the holistic employment picture remains robust, and deterioration thus far has been quite modest.

We expect the gradual shift in the labor market to eventually exacerbate the existing strain on lower-end consumers, which is readily apparent in consumer data and commentary we receive from corporate management teams. Excess savings in the U.S. has declined from a post-COVID peak of $1.7 trillion to -$750 billion.[8] The savings rate in the U.S. has declined to the lowest level since recovering from the Global Financial Crisis (GFC), while 90-day delinquencies on credit cards and auto loans have climbed to levels last reached coming out of the GFC, and 90-day delinquencies on home mortgages have also recently begun to increase.[9] Housing starts, housing permits and existing home sales are all decreasing.[10] In the second quarter we received commentary from company management teams — particularly in the quick service restaurant (QSR) and retail industries — that provided further evidence of a strained lower-end consumer. In the QSR segment, management teams detailed plans for upcoming value deals in response to declining volume, and a particular team in the auto retail segment articulated a consumer trend away from premium tire brands toward value brands, coupled with a proclivity to replace two tires instead of all four. In aggregate, the U.S. consumer remains healthy, but it is apparent that health is at least modestly degrading, and the financial strain of the lower-end consumer is already fully apparent.

The corporate fundamentals of high yield issuers remain strong on a historical basis and are supportive of historically tight average spreads. As with the aforementioned trends, however, peak health is in the rearview. According to J.P. Morgan, first quarter earnings released in the second quarter of 2024 depict essentially flat revenue and EBITDA[11] growth of 1.5% and -0.3%, respectively — marking four consecutive quarters of marginal-to-negative top- and bottom-line growth. Profit margins, under pressure from cost inflation, decreased to a three-year low of 15.1% in the first quarter. Illustrating the bifurcation consistent with recent quarters, year-over-year EBITDA growth in the gaming/lodging/leisure and industrials sectors remained above 10% in the first quarter, while EBITDA growth declined -17.0% in chemicals, -15.2% in services, and -13.4% in the telecommunications sector.[12] The average leverage (debt-to-EBITDA ratio) of high yield issuers remains quite healthy, but increased modestly quarter-over-quarter, from 3.93x to 3.98x.[12] Meanwhile, interest expense increased 10.7% for the trailing 12-month period and coverage (EBITDA-to-interest expense) decreased to 4.89x.[12] Though well below post-COVID peaks, interest coverage of high yield issuers remains historically healthy and stands in stark contrast to median interest coverage of approximately 1.71x for the average private loan issuer.[12]

2 Source: ICE Data Indices, Morgan Stanley Investment Management. Data as of 30 June 2024.
5 Source: Federal Reserve. Data as of 12 June 2024.
6 Source: Institute for Supply Management. Data as of 1 July 2024.
7 Source: Bureau of Labor Statistics. Data as of 7 June 2024.
8 Source: U.S. Bureau of Economic Analysis, Morgan Stanley Investment Management. Data as of 28 June 2024.
9 Source: Federal Reserve. Data as of 14 May 2024.
10 Source: National Association of Homebuilders. Data as of 20 June 2024.
11 Earnings before interest, taxes, depreciation and amortization.
12 Source: J.P. Morgan. Data as of 12 June 2024.

Primary issuance in high yield remained elevated in the second quarter of 2024, totaling approximately $77.9 billion, contributing to year-to-date issuance of $165.5 billion.[4] Issuers continued to take advantage of receptive capital markets to aggressively address the previously overemphasized maturity wall, which has largely become a non-issue for all but the bottom decile of high yield issuers, where access to capital markets remains constrained. This sharp focus on refinancing has resulted in less than $60 billion of bonds with a final maturity before year-end 2025 still outstanding.[13] The seniority of second quarter issuance was also notable, where the recent trend in secured bonds began to fade in favor of more traditional unsecured bonds. It should be noted that the percentage of high yield bonds outstanding that are secured remains at record levels. We expect the primary market will remain active but likely moderate somewhat in the second half of 2024, and we anticipate gross new-issue volume in the region of $275 billion for full-year 2024, representing an approximate 60% increase over 2023. Constrained access to capital for lower-rated issuers will be a key component affecting distress and ultimately default activity over the next one to two years.

The pace of liability management exercises (LMEs) among high yield bond and leveraged loan issuers remains elevated; however, the aggregate volume of distressed exchanges and traditional defaults has come in lower than we previously expected. The trailing 12-month par-weighted default rate for high yield issuers, inclusive of distressed exchanges, decreased from 2.59% at the end of the first quarter to 1.79% in the second quarter, aided in part by a higher volume of default activity in the second quarter of 2023 rolling off the 12-month period.[4] We expect default and LME activity will likely increase modestly in the second half of 2024 and likely plateau into 2025, with large ICE BofA U.S. High Yield Index constituents in the cable & satellite TV, health care and telecommunications sectors the most likely areas of distress. In the high yield market specifically, this expected activity remains effectively priced into quarter-end valuations, with 7.35% of the face value of the ICE BofA U.S. High Yield Index trading with a spread wide of 1,000 bps, and an average price of approximately $65.30 for this cohort relative to a trailing 12-month recovery rate in high yield of approximately 35%.[13]

We begin the second half of 2024 with a historically attractive average yield in our market and an average spread that still ranks near cycle lows. There remains a relatively tight range of valuations across non-distressed credits, with a growing divide between the CCC-rated segment and the remainder of the market as the distressed cohort continues to weigh on the average valuations in the lower-rated segment. The average spread in high yield ended the quarter at 343 bps, in close proximity to the 10-year lows, with the average option-adjusted spread ex-distress finishing the quarter inside 250 bps.[13] Despite meager quarter-over-quarter movement in these metrics, the incremental spread relationship between the CCC and single-B segments increased from 539 bps to 639 bps and, over the same period, the CCC/BB spread ratio increased from 4.11 to 4.61, highlighting the growing divide between distressed high yield and the remainder of the market.[13] This divide is also evident in the average spreads in the historically defensive sectors of telecommunications and cable & satellite TV, which continue to trade near decade-highs and appropriately reflect deep underlying credit risk driven by secular headwinds, high leverage, creditor-unfriendly capital allocation decisions, and the elevated likelihood of future LMEs. Despite generally tight valuations across much of our market, there remains opportunity. We continue to identify idiosyncratic situations to capture spread compression in segments experiencing secular growth, where issuers are able to decrease leverage through a combination of earnings growth and prudent capital allocation.

Our strategy remains slightly under-risked relative to the Bloomberg U.S. Corporate High Yield Index. We are not becoming more defensive and our outlook for the asset class is not bearish. Our lower-risk profile is primarily a function of our very limited exposure to troubled situations where we anticipate a high likelihood of a liability management exercise resulting in an adverse outcome for creditors. In select situations, we will invest in these credits when we feel risk compensation is adequate and we can leverage our expertise and institutional relationships to our advantage. It is worth emphasizing that a historically low average spread in the high yield market is warranted given the evolution of our market, and we do not view it as a source of significant concern. Wider peak spreads feel likely; however, expectations for peak spread levels are tempered. The BB share of the ICE BofA U.S. High Yield Index is nearly 53%, and a record-high 35% of the index is secured.[13] Additionally, the evolution of portfolio trading, or "PT trading," has enabled managers to execute at lower bid-ask spreads, arguably decreasing the necessary liquidity premium built into spreads.

The unique combination of a historically attractive yield, generally supportive fundamentals and a relatively high quality profile should continue to attract the capital of global institutional investors and provide continued support for the high yield market. At the same time, an element of caution remains warranted, and we are closely monitoring several catalysts that have the potential to induce volatility in our market. These include the aforementioned deteriorating lower-end U.S. consumer, strained supply-and-demand dynamics in commercial real estate, an approaching presidential election, and wars on multiple continents. These risks, however, can also present opportunity. We will continue to spend our time concentrating on what we do best — focusing on bottom-up fundamental credit analysis with a discerning eye on relative value, as we seek to generate positive risk-adjusted alpha for our clients.

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

Fund Facts

Launch date	04 December 2014
Base currency	U.S. dollars
Benchmark	Bloomberg US High Yield 1-5 Year Cash Pay 2% Issuer Capped Index

[4] Source: J.P. Morgan. Data as of 1 July 2024.
[13] Source: ICE Data Indices, J.P. Morgan, Morgan Stanley Investment Management. Data as of 1 July 2024.

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	4.02	11.04	-8.96	6.10	4.35	10.65	1.06	7.24	13.27	-0.68	--
Bloomberg US High Yield 1-5 Year Cash Pay 2% Issuer Capped Index	2.80	12.20	-5.90	6.07	4.49	9.88	0.12	6.38	16.19	-5.08	--

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 June 2024 and subject to change daily.

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INDEX INFORMATION

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The **Bloomberg U.S. Corporate High Yield Index** measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The Index excludes emerging market debt.

The **ICE BofAML U.S. High Yield Master II Constrained Index (ICE BofAML US High Yield)** is a market-value-weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment-in-kind securities. Its securities have maturities of one year or more and a credit rating lower than BBB-/Baa3, but are not in default.

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