Morgan Stanley Institutional Fund

# Global Fixed Income Opportunities Fund

**BROAD MARKETS FIXED INCOME TEAM**

## Performance

In the quarter period ending September 30, 2024, the Portfolio's I shares returned 3.99% (net of fees)[1], while the benchmark returned 4.24%.

## Market Overview

Risk markets posted strong gains in the third quarter, lifted by an increasingly dovish outlook for Federal Reserve (Fed) rate policy. Despite dramatic developments in the U.S. presidential race and escalating wars overseas, markets were intensely focused on when the Fed would join other central banks in cutting interest rates, which it did in mid-September. Expectations for further central bank easing, combined with signs of slowing growth in major economies, pushed bond yields lower globally. In the declining rate environment, the Bloomberg Global Aggregate Bond Index returned 6.98% for the quarter.

In late July, the Federal Open Market Committee (FOMC) held interest rates steady for an eighth consecutive meeting but signaled a cut in September. Any doubts about an imminent start to the Fed's easing cycle were dispelled days later with the release of the July employment report, which showed a sharp slowdown in job growth and the highest unemployment rate since 2021. Fed Chair Powell then gave a very dovish speech at the August Jackson Hole Economic Symposium, saying "the time has come for policy to adjust." The FOMC made good on his pledge at its September meeting, reducing the federal funds rate target 0.50% to a range of 4.75%-5.0% and projecting an additional 0.50% of cuts by year-end. So, with the labor market softening and other economic data coming in slightly weaker on balance, the oversized cut fueled concerns that the FOMC had maintained its restrictive stance for too long. However, comments from Fed Governor Waller reassured markets that a soft landing was still on track.

Outside the U.S., several developed market central banks continued lowering policy rates in response to moderating inflation, including the European Central Bank and Bank of Canada. In addition, the Bank of England made its first rate cut since 2020 in August. The Bank of Japan remained an outlier among its peers, raising rates for the second time this year as weakness in the yen added to upside inflation risks. In emerging markets, China continued to grapple with slowing growth and deflationary pressures, prompting monetary authorities to unveil the largest stimulus package since the pandemic.

Treasury yields across the curve fell significantly during the quarter. Short rates declined more than long rates, ending the longest yield curve inversion (between 2- and 10-year maturities) on record. Investment grade and high yield spreads widened in early August after the weak July jobs report. However, spreads quickly recovered in response to some encouraging economic data, including a drop in initial jobless claims, and finished the quarter roughly where they had started.

Against this backdrop, all major sectors of the Bloomberg U.S. Aggregate Index performed well. Of note, non-agency commercial mortgage-backed securities (CMBS), which are very interest rate sensitive, generated solid gains across property types — even office.

## Fund Strategy and Performance

During the quarter, both the portfolio's macro decisions and positioning within spread sectors contributed to absolute performance. The portfolio's long duration exposures in the U.S. and euro area were the largest contributors to performance as global government bond yields fell over the quarter. Long duration exposures in the emerging markets, particularly in Peru and Colombia, also contributed. Higher "risk-free" rates also continued to benefit performance.

Within currency positioning, the long Australian dollar vs. short Canadian dollar position contributed while emerging markets currencies detracted slightly.

Regarding positioning within spread sectors, the portfolio's largest exposure, securitized credit, continued to add to performance, particularly the exposures to non-agency residential mortgage-backed securities (RMBS) and CMBS. The exposures within investment grade and high yield corporates also contributed as spreads tightened.

[1] Source: Morgan Stanley Investment Management. Data as of September 30, 2024. Performance for other share classes will vary.

This document constitutes a commentary and does not constitute investment advice nor a recommendation to invest. The value of investments may rise as well as fall. Independent advice should be sought before any decision to invest.

**NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT**

## Outlook

Bonds maintained their impressive performance throughout September, as yields declined across most government bond markets, accompanied by a modest tightening of credit spreads. In a departure from August, it was the non-U.S. Treasury markets that took the lead, with yields dropping by double digits—except in the U.K. and Japan. Economic indicators continued to raise concerns, particularly regarding Europe's growth outlook, while the U.S. labor market remained under scrutiny following a disappointing July report. The good news is that the U.S. labor market did not deteriorate further in August; however, it also showed little improvement, leaving market participants anxious about the ongoing downward trend. Historical patterns indicate that once the unemployment rate begins to rise, as it has, it often continues to worsen until the Federal Reserve's monetary policy or other fiscal policies intervene. While we believe there are mitigating factors this time that make the current unemployment rate less alarming, the Fed—being the world's foremost risk manager—should still take heed.

And heed they did. The pivotal news that significantly boosted markets was the Fed's decision to cut interest rates by 50 basis points[2] and to project an additional 50 basis points of rate cuts this year. This marked a dramatic shift from June, when they anticipated only a single rate cut of 25 basis points in 2024. The market had been bracing for a less aggressive stance, and the Fed's decision underscored their concerns that, with inflation declining and unemployment rising, current policy rates were overly restrictive. Similarly, the European Central Bank also opted for rate cuts, citing improving inflation and a weak growth outlook.

The Fed's action is noteworthy. It signals a proactive approach aimed at easing restrictions before the economy shows signs of significant weakening or unemployment rises well above normal levels. With the U.S. economy increasingly appearing to align with long-term growth and inflation targets, maintaining such tight policy is no longer necessary. In essence, if the economy is performing "normally," shouldn't interest rates reflect that as well? Consequently, the Fed has initiated a recalibration of monetary policy. The pressing question now is: How much recalibration is warranted? The market is anticipating considerable rate cuts in both this year and the next, projecting the fed funds rate to drop to 3% by early 2026—an ambitious forecast.[3] Given that U.S. inflation remains above target and gross domestic product growth is robust, the extent of necessary rate cuts remains uncertain. Reducing rates by 100 basis points is relatively achievable, as even at a 4.5% policy rate, monetary policy is still tight. However, for the Fed to lower rates below 4%, it will require more compelling evidence that labor markets will further deteriorate or that inflation will quickly align with targets. While this scenario is possible, it is not our base case.

With US Treasury yields hovering around 3.8%, at about the same level we started the year, it will be difficult for yields to fall further unless we see a significant deterioration in data (i.e. the unemployment rate going over the peak of the Fed's forecast of 4.4%). Given the amount of rate cuts the market is already pricing, it is difficult to forecast further drops in yields. On the other hand, the trend in U.S. employment has been weaker, which makes it difficult to oppose the third quarter bull market. In either case, volatility will still abound as markets and policy reactions remain data dependent. We believe a neutral to slightly underweight duration position in the U.S. looks appropriate. We see better value outside the U.S., in Europe, where economic growth is anemic and central banks are responding, and in Asia, where countries like New Zealand are experiencing weaker growth and are falling behind in the rate-cutting cycle.

Credit markets also continue to perform. 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. Even given the backdrop, credit spreads — both investment grade and high yield — are struggling to move lower. Both are at the tight end of their historical ranges (European investment grade looks more attractive) and will be challenged to tighten further. Markets are punishing underperformers, and as credit spreads most likely move sideways over the fourth quarter, security selection will be increasingly more important. It will be difficult to make up for losses due to poor security selection.

Our credit market strategy is focused on avoiding those problematic companies and building in as much yield in the portfolio without taking undue risks. There is little reason to believe spreads will materially widen when economic growth is decent and central banks are cutting interest rates. Yield-oriented buying should contain spread widening, but any pullback in demand could be problematic. 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. In the portfolio, we remain modestly overweight credit with a modest bias to higher quality.

Emerging market local debt returns were also quite strong over the month with several countries performing well. Countries with solid economic outlooks, decent growth, falling inflation and a central bank able and willing to cut rates have tended to perform well. Although, like corporate credit, when markets grow disappointed, bonds and currencies can underperform quickly. Country and security selection remain pertinent. 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 favorable risk/reward characteristics such as the Dominican Republic, Colombia and Peru.

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,

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[2] One basis point = 0.01%
[3] Source: Bloomberg L.P. Data as of September 30, 2024.

especially as house prices remain firm. U.S. agency mortgage securities remain relatively attractive versus investment grade corporates, at least the higher coupons, and we believe they are likely to outperform U.S. Treasury bonds. Similar to our positioning in corporate credit, we are looking to move up in credit quality and out of non-U.S. structures given tighter spreads and increased macroeconomic risks in Europe.

In currency markets, the outlook for the U.S. dollar remains unclear. While it has weakened due to the decline in U.S. interest rates, we are not as confident about the likely extent of future rate cuts. However, it is possible the Fed's commitment to its employment mandate may compel it to adopt a more dovish stance, potentially even more so than other central banks that are faced with weaker economies. Despite the slowdown in the U.S., the economy is still growing faster than most other countries, suggesting that any rate cuts could bolster the U.S. economy and dollar.

As of now, however, it remains unclear who can surpass the U.S. as the global growth leader. Europe and China are facing lackluster cyclical data, compounded by structural challenges. Other emerging market economies continue to be confronted with idiosyncratic challenges. Their currencies continue to be positively affected by easier U.S. monetary policy but remain subject to a variety of local risks which may or may not overcome the risk-on bias of G7 central bank easing. We will look to capitalize on idiosyncratic mispricings where there are clear fundamental and value differences.

## Fund Facts

| | |
|---|---|
| Inception Date | July 28, 1997 |
| Minimum Initial Investment ($)* | A Shares - 1,000 |
| | I Shares - 1,000,000 |
| Benchmark | Primary- Bloomberg Global Aggregate Hedged USD Index |
| | Custom- Blended Index |
| | Former- Bloomberg Global Aggregate Index |
| **Class I expense ratio** | **Gross 0.60 %** |
| | **Net 0.60 %** |
| **Class A expense ratio** | **Gross 0.86 %** |
| | **Net 0.86 %** |

**Where the net expense ratio is lower than the gross expense ratio, certain fees have been waived and/or expenses reimbursed. These waivers and/or reimbursements will continue for at least one year from the date of the applicable fund's current prospectus (unless otherwise noted in the applicable prospectus) or until such time as the fund's Board of Directors acts to discontinue all or a portion of such waivers and/or reimbursements. Absent such waivers and/or reimbursements, returns would have been lower. Expenses are based on the fund's current prospectus, in effect as of the date of this commentary. For information on the applicable fund's current fees and expenses, please see the fund's current prospectus.**

***** Share class availability may vary by platform. For more information, please visit the specified fund page on the website.

## Performance (%)

| *As of September 30, 2024* | MTD | QTD | YTD | 1 YR | 3 YR | 5 YR | 10 YR |
|---|---|---|---|---|---|---|---|
| Class I Shares at NAV | 1.25 | 3.99 | 6.52 | 12.10 | 2.36 | 2.67 | 3.34 |
| Class A Shares at NAV | 1.25 | 3.99 | 6.23 | 11.80 | 2.07 | 2.40 | 3.05 |
| Class A Shares (With Max 3.25% Sales Charge) | -1.98 | 0.63 | 2.80 | 8.26 | 0.96 | 1.73 | 2.72 |
| Bloomberg Global Aggregate Hedged USD Index | 1.16 | 4.24 | 4.38 | 10.63 | -0.22 | 0.57 | 2.33 |
| Blended Index | 1.16 | 4.24 | 4.38 | 10.63 | -0.22 | 0.57 | 1.39 |
| Bloomberg Global Aggregate Index | 1.70 | 6.98 | 3.60 | 11.99 | -3.06 | -0.83 | 0.57 |

**Performance data quoted represents past performance, which is no guarantee of future results, and current performance may be lower or higher than the figures shown. For the most recent month end performance figures, please visit morganstanley.com/im. Investment returns and principal value will fluctuate and fund shares, when redeemed, may be worth more or less than their original cost.**

Returns are net of fees and assume the reinvestment of all dividends and income. They are compared to an unmanaged market index. Returns for less than one year are cumulative (not annualized). Performance for one year or more is based on average annual total returns. The returns are reported for Class I and A shares. Performance for other share classes will vary.

Please keep in mind that high double-digit returns are highly unusual and cannot be sustained. Investors should also be aware that these returns were primarily achieved during favorable market conditions.

Effective January 1, 2017, the benchmark index for the MS Global Fixed Income Opportunities Fund changed from Bloomberg Global Aggregate Index to the Bloomberg Global Aggregate Hedged USD Index. Blended Index performance shown is calculated using the Bloomberg Global Aggregate Index from inception through 12/31/2016 and the Bloomberg Global Aggregate Hedged USD Index thereafter.

### INDEX INFORMATION

The **Bloomberg Global Aggregate Hedged USD Index** provides a broad-based measure of the global investment grade fixed-rate debt markets. Total Returns shown is hedged USD.

**Blended Index** performance shown is calculated using the Bloomberg Global Aggregate Index from inception through 12/31/2016 and the Bloomberg Global Aggregate Hedged USD Index thereafter.

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 **Bloomberg U.S. Aggregate Index** tracks the performance of all U.S. government agency and Treasury securities, investment-grade corporate debt securities, agency mortgage-backed securities, asset-backed securities and commercial mortgage-backed securities.

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### RISK CONSIDERATIONS

There is no assurance that a mutual fund will achieve its investment objective. Funds are subject to market risk, which is the possibility that the market values of securities owned by the fund will decline and that the value of fund shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this fund. Please be aware that this fund may be subject to certain additional risks. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments **(credit risk)**, changes in interest rates **(interest-rate risk)**, the creditworthiness of the issuer and general market liquidity **(market risk)**. In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. Certain **U.S. government securities** purchased by the Strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **High yield securities ("junk bonds")** are lower rated securities that may have a higher degree of credit and liquidity risk. **Public bank loans** are subject to liquidity risk and the credit risks of lower rated securities. **Foreign securities** are subject to currency, political, economic and market risks. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed countries. **Sovereign debt securities** are subject to default risk. **Derivative instruments** may disproportionately increase losses

and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). **Collateralized mortgage obligations (CMOs)**can have unpredictable cash flows that can increase the risk of loss. **Portfolio Turnover.** Consistent with its investment policies, the Fund will purchase and sell securities without regard to the effect on portfolio turnover. Higher portfolio turnover will cause the Fund to incur additional transaction costs.

## IMPORTANT INFORMATION

The views and opinions and/or analysis expressed are those of the investment team as of the date of preparation of this material and are subject to change at any time without notice due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all investment personnel at Morgan Stanley Investment Management (MSIM) and its subsidiaries and affiliates (collectively "the Firm"), and may not be reflected in all the strategies and products that the Firm offers.

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