Morgan Stanley
INVESTMENT MANAGEMENT

COMMENTARY
June 30, 2025

Morgan Stanley Institutional Fund

High Yield Portfolio

HIGH YIELD TEAM

Performance

In the quarter period ending June 30, 2025, the Portfolio's I shares returned 3.64% (net of fees)[1], while the benchmark returned 3.53%.

Midstream and retailers were the Fund's top-performing sectors relative to the benchmark during the second quarter. Relative outperformance in midstream was driven by favorable credit selection and was led by a lack of exposure to a struggling integrated gas to energy company. The company released first quarter earnings in May that missed expectations by a significant margin. Additionally, despite using asset sale proceeds to pay down debt in May, the company continues to be under scrutiny as it needs to find ways to raise liquidity and pay down additional debt. Relative outperformance in retailers was driven by sound credit selection and an underweight position. The primary individual contributor was a lack of exposure to a department store conglomerate. The company continued to struggle in the second quarter and has reportedly had challenges paying vendors, which is causing liquidity concerns to mount.

Automotive and consumer cyclical services were the Fund's worst-performing sectors relative to the benchmark during the period, both driven by challenging credit selection. In automotive, an overweight position in an auto parts supplier was the primary detractor. The company's first quarter earnings, released in June, were weak. The primary individual detriment in consumer cyclical services was an overweight position in a provider of interior design and finish solutions. The company has been contending with installation declines, a business mix shift toward less profitable business lines, and increasing leverage. First quarter earnings came in below expectations and, in May, the company announced the current CEO's departure.

From a credit quality perspective, credit selection in B-rated and BB-rated bonds contributed positively to relative returns. A modest allocation to BBB-rated bonds also helped relative performance. Conversely, adverse credit selection in bonds rated CCC or below hurt relative returns. An underweight position in BB-rated bonds and an overweight position in B-rated bonds also detracted from relative performance.

Market Review

The U.S. and global high yield markets got off to an exceptionally volatile start in the second quarter, but risk markets ultimately stabilized in late April and gave way to strong performance in May and June. The strength in the final two months was somewhat remarkable, as the high yield market seemingly shrugged off multiple headwinds, including a U.S. credit rating downgrade, unresolved trade negotiations between the U.S. and most of its trading partners, the looming passage of a U.S. budget bill that would likely balloon deficit spending and spur additional inflation, and fresh conflict between the U.S., Israel and Iran. Technical conditions were particularly weak in the first several weeks of the quarter, but conditions improved as strong inflows returned and primary market activity quickly normalized.[2]

In April, the U.S. and global high yield markets suffered acute volatility. Following the Trump administration's Liberation Day tariff announcements, the average spread-to-worst in the U.S. high yield market leapt by approximately 100 basis points (bps) over the subsequent four trading days, before reaching a mid-month peak of approximately 475 bps as investors shifted capital to higher quality assets amid increased recession fears.[3] U.S. high yield retail funds set a record for weekly withdrawals in the second week of the month, while the primary market was virtually shuttered until late April. Ultimately, the high yield market was orderly and price discovery was efficient, bid-ask spreads widened but remained relatively range-bound, and institutional capital provided for willing buyers at appropriate, lower levels.[2]

The high yield market broadly recorded competitive returns in May. Credit markets contended with volatile — and ultimately higher — Treasury yields, amid mounting U.S. fiscal concerns, an unsurprising U.S. downgrade, and simmering trade tensions, particularly between the U.S. and China. The yield on the 5-year Treasury ended the month approximately 25 bps higher. Strong demand for leveraged credit and healthy volumes of rising stars (bonds upgraded from high yield to investment grade) dampened the net supply surplus in May and contributed to substantial spread tightening that more than offset the jump in Treasury yields. Distressed

[1] Source: Morgan Stanley Investment Management. Data as of June 30, 2025. Performance for other share classes will vary.
[2] Source: Bloomberg L.P., Morgan Stanley Investment Management. Data as June 30, 2025.
[3] Source: ICE BofA U.S. High Yield Index, Morgan Stanley Investment Management. Data as of June 30, 2025. One basis point = 0.01%

exchange volume dissipated, while the volume of missed coupon payments increased. In aggregate, the backdrop was sufficiently supportive to fuel the strongest monthly return for the U.S. high yield market in nearly a year.[2]

Performance in the U.S. and global high yield markets grew even stronger in June amid a meaningful drop in Treasury yields and a deep bid for risk, with the S&P 500 Index closing the quarter at a new record high. The market showed little reaction to the Iran-Israel conflict, though upon the ceasefire oil futures fell into the mid-$60s.[2] Primary market volume again increased and was met with ample demand as investors' concerns over tariffs lessened and expectations for future interest rate cuts increased.

For U.S. high yield issuers, first quarter earnings released in the second quarter showed a moderate decline, with barely positive revenue and earnings growth and higher interest expense, according to J.P. Morgan.[4] The trailing 12-month par-weighted default rate ended the first quarter at 0.43%, or 1.41% including distressed exchanges.[5]

Primary market activity increased quarter-over-quarter despite a slow start, and demand was broadly strong post the initial weakness. Issuance totaled $77.3 billion in the second quarter. Refinancing accounted for 68.1% of quarterly issuance, and acquisition financing accounted for 19.1%. According to preliminary Lipper estimates, U.S. high yield retail funds experienced a net outflow of only $100 million in the second quarter, inclusive of an outflow of nearly $11 billion in April alone.[5]

The Bloomberg U.S. Corporate High Yield Index returned 3.53% for the three months ending June 30, 2025.[2]

Outlook

We begin the second half of 2025 with a cautious outlook. We think peak risk and volatility emanating from evolving tariff and trade policy is likely behind us; however, the ultimate framework of international trade with the U.S. remains unclear. We expect the new framework will likely continue to impede economic growth and will likely act in concert with the budget bill to stimulate higher — and stickier — inflation, as the federal deficit under the current bill would continue to balloon. Yields remain historically attractive, but the average spread in the high yield market, while approximately 50 bps above post-Global Financial Crisis (GFC) lows, reached in January, finished the second quarter below where it began the period and is susceptible to widening.[3] We come to this conclusion after a thorough analysis of factors including U.S. and global economic growth, the evolving monetary policy of global central banks, consumer health, the fundamentals of high yield issuers, technical conditions, and valuations. Ultimately, while we believe the likelihood of a recession this year is low, we believe that caution is warranted and expect additional bouts of volatility in the months ahead.

The U.S. economy entered 2025 on positive footing before contracting in the first quarter for the first time since 2022, with a reported U.S. gross domestic product (GDP) of -0.5%, following growth of 2.4% in the final quarter of 2024.[6] Contraction in the U.S. economy in the first quarter was driven by a U.S. goods and services trade deficit, as companies increased imports ahead of the Liberation Day tariff announcements on April 2.[7] Meanwhile, underlying domestic demand in the first quarter was positive. The trade deficit has moved quickly back toward normalization, shrinking a reported 55.5% in April as exports rose 3.0% and imports decreased 16.3%.[7] The May Institute for Supply Management (ISM) Report On Business released in June showed slowing business activity in manufacturing and services, with both Manufacturing and Services purchasing managers' index (PMI) readings below 50.[8] Moving forward, we expect economic growth in the U.S. will likely remain slow due to headwinds such as evolving and uncertain trade policy, marginally tighter lending standards, a weaker labor market and softening demand. The four-week average of initial jobless claims currently sits at year-to-date highs, while continuing claims appear to be on the rise, and the U-6 underemployment rate registered 7.8% in May, remaining near the cycle high of 8.0% reached in February.[2,9] While we expect economic growth in the U.S. to be lackluster over the near term, the likelihood of a recession appears lower than it did during peak tariff uncertainty late in the first quarter and early in the second quarter. Prevailing sentiment among business leaders and consumers appears to support our assessment. A June release of the CEO Confidence Index showed that, of 133 CEOs surveyed, 51% believe business conditions will improve this year as trade negotiations settle, and 67% expect to grow revenue in 2025, up from 53% in the May survey.[10]

As economic growth in the U.S. slows, we expect growth in the U.K. and Europe will likely also remain moderate, with the expectation for the strongest growth in Europe. The U.K.'s economy grew at a reported 0.7% in the first quarter, and the U.K. Office for Budget Responsibility is projecting growth to slow to 0.1% in the second quarter before marginally accelerating in the second half

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2 Source: Bloomberg L.P., Morgan Stanley Investment Management. Data as June 30, 2025.
3 Source: ICE BofA U.S. High Yield Index, Morgan Stanley Investment Management. Data as of June 30, 2025. One basis point = 0.01%
4 Source: J.P. Morgan. Data as of June 12, 2025.
5 Source: J.P. Morgan. Data as of July 1, 2025.
6 Source: U.S. Bureau of Economic Analysis. Data as of June 26, 2025.
7 Source: U.S. Bureau of Economic Analysis: U.S. International Trade in Goods & Services. Data as of June 5, 2025.
8 Source: Institute for Supply Management. Data as of June 2, 2025.
9 Source: U.S. Bureau of Labor Statistics. Data as of June 6, 2025.
10 Source: Chief Executive Research. Data as of June 9, 2025.

of the year to 0.3% by the fourth quarter.[11] In Europe, growth accelerated to an annualized 2.4% in the first quarter, marking the strongest print in several years.[12] The European Central Bank (ECB) is projecting full-year growth of 0.9% this year and 1.1% growth in 2026.[12] These projections are consistent with indicators from the Organisation for Economic Co-operation and Development (OECD) that point toward strong, above-trend growth throughout most of Europe and a slowdown in the U.S.[2]

Global central banks are navigating a precarious period with divergent and uncertain inflation backdrops across regions. The previously discussed uncertainty regarding trade policy, in addition to the generally slow economic growth backdrops and shifting fiscal priorities, are further complicating the path of key policy rates. In Europe, realized and expected inflation are tame, and recent policy action reflects it. In May, headline inflation in the eurozone was approximately 1.9% year-over-year, and core inflation 2.3%.[12] The ECB is projecting inflation will average 2% for 2025, before slowing to 1.6% in 2026.[12] Expectations for moderate inflation and slow growth prompted the ECB to lower its key policy rate by another 25 bps in June, to 2.0%.[12] Despite the ECB stating in June that rates could be on hold following this seventh cut in the rate-cutting cycle, the market ended the second quarter pricing in one additional cut for this year. In the U.K., year-over-year inflation reached 4.1% in April and 4.0% in May, but the Bank of England still decided to reduce its key policy rate to 4.25% in May, likely prompted by very weak economic growth.[11] Meanwhile, in the U.S., accelerating inflation is widely anticipated, though its elusiveness has complicated Federal Reserve (Fed) policy decisions. For the first two months of the second quarter, the U.S. core consumer price index (CPI) on a three-month basis was running below its 12-month rate. This was driven by limited goods inflation and a moderation in housing inflation. However, we expect to see a pickup in goods inflation as businesses look to preserve margins and pass on rising input costs. In May we observed a month-over-month increase in the ISM Prices Paid gauge, which historically has led core CPI by three months.[2,8] In light of above-target realized inflation, a labor market that has only recently showed modest signs of weakening, and uncertainly regarding fiscal and trade policy, the Fed remained on hold in June. We expect the Fed will likely reduce its key policy rate later this year on weakening labor data, even with inflation above target, as it begins to move toward a target range of 3%-3.5%.

U.S. consumer health is generally supportive as we transition through the summer; however, we continue to closely monitor it given the already compromised health of the lower-end consumer and the headwinds they face, particularly the softening employment picture, inflation, and the resumption of student loan payments that were deferred under the Biden administration. In aggregate, the lower-end consumer remains weak but relatively stable. While the delinquency rate on credit card loans remains near the highest level since 2012, it showed a small decline to 3.05% in the first quarter, while the delinquency rate on consumer loans increased to 2.77%, a level last reached in 2012.[13] This compromised state is consistent with the reduction in consumer spending, which slowed to 0.2% in April from 0.7% in March.[6] Additionally, 27% of respondents to The Conference Board's Consumer Confidence Survey in May said they had recently dug into savings to pay for goods or services, and nearly 19% classified jobs as "hard to get," up from 17.5% of those polled in April.[14] We expect the balance of these metrics to slowly deteriorate further as labor and inflationary headwinds strengthen. Over the near term, we are not concerned by the low probability of a sharp decline in consumer health; we are more focused on the potentially rapid impact that volatility and uncertainty can have on consumer discretionary spending and the follow-on impact on issuer fundamentals.

The fundamentals of high yield issuers remain healthy in a historical context, but first quarter earnings released in the second quarter depict a return to modest degradation after a slight improvement in the fourth quarter of 2024. Top- and bottom-line growth slowed and struggled to remain positive, margins continued to weaken, and leverage increased, and interest coverage decreased once again after isolated improvement in the prior quarter. According to J.P. Morgan, first quarter earnings released in the second quarter show revenue growth of 1.4% and EBITDA[15] growth of 0.7%. At the same time, profit margins deteriorated for the third consecutive quarter, falling from 14.9% to 14.4% in the first quarter, relative to a recent peak of 16.6% in the first quarter of 2023.[4] Earnings across sectors were broadly weaker, with the notable laggards being media, housing, retail and transportation, which each experienced a year-over-year earnings decline of over 40%.[4] The average leverage (debt-to-EBITDA ratio) of high yield issuers remained healthy in a historical context, though increased from 3.98x to 4.08x in the first quarter, remaining well below the long-term average.[4] Telecommunications, transportation and media are the most aggressively levered sectors in high yield. Meanwhile, interest expense increased 2.6% for the trailing 12-month period ending March 31, and coverage (EBITDA-to-interest expense) decreased from 4.73x to 4.70x.[4] Though well below post-pandemic peaks, interest coverage of high yield issuers remains historically healthy relative to a long-term average of 4.5x.[4]

After peak volatility related to tariff uncertainty subsided, the pace of primary issuance in the high yield market accelerated at the end of April, and it remained elevated for the remainder of the quarter. Ultimately, the second quarter saw healthy issuance

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2 Source: Bloomberg L.P., Morgan Stanley Investment Management. Data as June 30, 2025.
4 Source: J.P. Morgan. Data as of June 12, 2025.
6 Source: U.S. Bureau of Economic Analysis. Data as of June 26, 2025.
8 Source: Institute for Supply Management. Data as of June 2, 2025.
11 Source: Office for National Statistics, United Kingdom. Data as of June 18, 2025.
12 Source: European Central Bank Data Portal. Data as of June 5, 2025.
13 Source: Board of Governors of the Federal Reserve System. Data as of May 21, 2025.
14 Source: The Conference Board: Consumer Confidence Survey. Data as of May 27, 2025.
15 Source: Earnings before interest, taxes, depreciation and amortization.

characterized by a high level of refinancing activity, contributing to a total gross issuance volume of $77.3 billion.[5] Following the spike in volatility in early April, issuers generally found a receptive investor base. The quality of issuance was notably high, with approximately 65% of issuance rated split-BB (rated BB by at least one major rating agency) or higher.[5] Lower-rated issuance remained remarkably limited. While one quarter of limited issuance from lower-rated issuers is not statistically significant, this trend has persisted since 2022. It bears watching given the greater portion of CCC-rated bonds that mature in the next two to three years relative to the single-B or BB-rated segments. Approximately 30% of outstanding CCC-rated bonds mature before June 2028.[3] Our estimate for full-year gross issuance volume has decreased given issuers' proclivity to sit on the sidelines during bouts of volatility and our expectation for an increase in such bouts over the next several quarters. Additionally, continued uncertainty regarding trade and tax policy as well as continued concern over slowing economic growth will likely weigh on merger and acquisition activity, at least marginally. Ultimately, though, we think a shift toward deregulation under the Trump administration and a lower regulatory hurdle for strategic consolidation should spur additional acquisition-related issuance across sectors such as oil and gas, cable, media, and telecommunications. Finally, institutional demand from global yield-based investors in the second quarter was remarkably firm, in aggregate. We expect demand from this cohort to remain supportive given historically attractive yields that we do not expect to contract materially over the balance of the year. We anticipate, however, that investors will likely be more discerning and less receptive to aggressive and lower-rated opportunities over the near-to-intermediate term.

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 in high yield bonds remains manageable and well below long-term averages. The trailing 12-month par-weighted default rate for high yield issuers, inclusive of distressed exchanges, increased modestly from 1.20% at the end of the first quarter to 1.41% by quarter-end. The same metric for loan issuers decreased to 3.79%.[5] Over the next several quarters, our base case is that default and LME activity in leveraged credit will likely remain elevated, with an increase in traditional defaults coming from companies that have executed an LME over the past couple of years, in an unsuccessful bid to right the ship. We expect the default rate for high yield bonds inclusive of distressed exchanges to remain well below the long-term average and likely finish 2025 in the context of 2%-2.5%. Approximately half of all LMEs re-default in the subsequent three years, and the elevated volume of LMEs over the last couple of years provides upside risk to default rates in the event of a contraction in economic growth. We expect this to be less of a risk this year, and more of a risk in 2026 and 2027. Quarter-end ICE BofA U.S. High Yield Index levels provide a glimpse into anticipated distress and expected credit losses: Anticipated credit losses decreased in the second quarter, with 5.18% of the face value of the index trading with a spread wide of 1,000 bps at quarter-end, down from 5.91% at the end of the first quarter.[3] The average price of this cohort is approximately $68.89, relative to a trailing 12-month recovery rate in high yield of approximately 37%.[16]

We begin the third quarter with an average spread that is approximately 50 bps lower quarter-over-quarter but nearly 50 bps above post-GFC lows, reached in January, and an average yield that is nearly 70 bps lower quarter-over-quarter but still well above the 10-year average.[3] The notable decompression in the incremental spread relationship between the CCC and single-B segments that began after reaching a low of 409 bps in January continued in the second quarter, as lower-rated risk underperformed on a relative basis.[3] This relationship widened from 543 bps at the beginning of the three-month period to a peak of 638 bps in April, before settling at 566 bps at quarter-end.[3] We expect that as the ultimate landscape of trade policy matures, and economic growth likely remains muted, the fundamentals of lower-rated issuers will likely face further degradation and this incremental spread relationship between the CCC and single-B segments should have room to widen. On balance, while we believe valuations across several segments of the high yield market will likely reach wider peak spreads in coming months, we believe there remains opportunity. We continue to identify idiosyncratic situations to capture spread compression in segments experiencing secular growth, but have also recently found compelling opportunities in cyclical sectors where bonds of less cyclical issuers have traded off in sympathy, despite historically resilient performance during cyclical downturns. Additionally, we have found select opportunities in challenged segments where neatly structured covenants, adequate loan-to-value ratios, and appropriate risk compensation form to represent compelling investment opportunities.

In the second quarter, our strategy took advantage of the volatility to add exposure to high conviction segments and issuers at more attractive valuations during periods of weakness, and to trim exposure amid market strength in areas where we have a less favorable view. During the pronounced weakness in April, our strategy added exposure to several cyclical commodity-related sectors where select companies with less cyclical business lines traded lower in sympathy with their sector. In the chemicals sector, we have found opportunities in water treatment and specialty chemicals producers, while staying away from the more cyclical parts of the sector, such as producers of titanium dioxide. We also selectively added exposure to high conviction names within the energy sector in April amid relative weakness across the sector. In more defensive sectors, we found attractive points to add to traditionally durable cash generative businesses that are either experiencing above-trend secular growth or are positioned to benefit from deregulation and

3 Source: ICE BofA U.S. High Yield Index, Morgan Stanley Investment Management. Data as of June 30, 2025. One basis point = 0.01%
5 Source: J.P. Morgan. Data as of July 1, 2025.
16 Source: J.P. Morgan. Data as of June 9, 2025.

increased strategic consolidation. Media, telecommunications and cable & satellite TV are not areas with attractive long-term growth prospects; however, we believe there are select opportunities in these sectors that are likely to benefit from a change in Federal Communications Commission (FCC) ownership rules, in the case of select companies in media, or likely to benefit from strategic consolidation in telecommunications and cable. Finally, the need of certain issuers with more challenging capital structures to access capital markets during less favorable periods created opportunities to capture attractive, above-market yield in individual issues with strong, tightly structured covenant packages.

In conclusion, we are in a less certain world relative to just three months ago. Fundamentals and technical conditions remain largely supportive and, on average, yield compensation is broadly appropriate; however, a June rally in Treasury yields coupled with moderate spread compression during the month resulted in valuations marginally more exposed to future bouts of volatility. We expect the balance of 2025 will likely be a competitive period for high yield, but certainly not a period without volatility. Geopolitical tensions, regional conflict and a fragile Iran-Israel ceasefire continue to present the potential for expansion or ultimate resolution. Amid a volatile and uncertain backdrop, 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.

Fund Facts

Inception Date	February 07, 2012
Minimum Initial Investment ($)*	A Shares - 1,000
	I Shares - 1,000,000
Benchmark	Bloomberg U.S. Corporate High Yield Index
Class I expense ratio	**Gross 1.16 %**
	Net 0.65 %
Class A expense ratio	**Gross 1.39 %**
	Net 1.00 %

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.

Performance (%)

As of June 30, 2025	MTD	QTD	YTD	1 YR	3 YR	5 YR	10 YR
Class I Shares at NAV	1.99	3.64	3.75	8.57	9.63	5.96	4.85
Class A Shares at NAV	1.96	3.55	3.60	8.19	9.28	5.59	4.47
Class A Shares (With Max 3.25% Sales Charge)	-1.31	0.22	0.18	4.61	8.07	4.88	4.13
Bloomberg U.S. Corporate High Yield Index	1.84	3.53	4.57	10.29	9.93	5.97	5.38

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.

INDEX INFORMATION

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 **ICE BofA U.S. High Yield Master II Constrained Index (ICE BofA 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.

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

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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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Please consider the investment objective, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus (which includes the applicable fund's current fees and expenses, if different from those in effect as of the date of this commentary), download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

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