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Manager Commentary

Emerging Markets Debt Faces Some New Challenges

By: Eric Fine, Portfolio Manager

Executive Summary

- We expect U.S. long-end rates to stay low even if rates at the front end of the curve rise
- Hard-currency still continues to outperform local-currency bonds
- Geopolitical risk could increase, especially in Eastern Europe
- Argentina default saga continues

Overview

Our basic stance remains, with one new risk (from U.S. high-yield) that we are accommodating, as well as one declining risk (from U.S. duration) that we are also accommodating. To reiterate the basics that best summarize our portfolio, we continue to prefer hard-currency over local-currency, want no investments with Russia-/Ukraine-related risk, and believe that a barbell of high- and low-yielders best describes the current results of our investment process.

One new risk we are in the process of seeking to accommodate is that from the ongoing exodus from U.S. high-yield funds – what are we doing about it? Whether due to ongoing concerns about duration, concerns about liquidity, pockets of economic weakness, and/or a retrenchment after a long period of growing ownership, high-yield weakness is a new fact concerning the market. Our response has been to examine the portfolio through this lens. Specifically, we have looked at emerging markets bonds that have high ownership on the part of U.S. high-yield and high-grade funds. Unless there are specific catalysts or mitigating factors, these types of investments are being reduced and/or eliminated. In terms of our formal process, this falls under the category of getting a lesser score for "correlation" risk – we saw some bonds as vulnerable to high correlation with a weakening high-yield market.

A potentially fading risk is generalized concern about duration – what are we doing about that? The bullish case for U.S. Treasuries is the European rates curve. Ten-year German Bunds are approximately 1% in Euros compared to approximately 2.4% in U.S. dollars for the 10-year Treasury, which is a major anchor for the U.S. curve. This anchor shows no sign of lifting soon, due to continued downside growth surprises and risks in the Euro area. For the U.S., although it is clearly the growth leader among the U.S./Eurozone/Japan economies, there are significant mitigating factors. Most importantly, growing geopolitical risk from an escalating conflict between the U.S. and Russia provides a risk-off bid to U.S. Treasury duration. Our summary view is that the U.S. long-end rates could be anchored, even if front-end rates may rise.

This is important to us for two reasons. First, it gives us comfort with the shorter-dated bonds already in the portfolio, as our investment process has generated investments with high spreads relative to their fundamentals. As a result, over a multi-month period, U.S. yield rises or declines could potentially see our bonds trade with stable prices and attractive carry. Second, some long ends of credit spread curves in emerging markets hard-currency bonds were showing the highest degree of attractiveness on our framework. Previously, we were worried about the potential correlation (via the correlation test in our investment process) of such long-dated bonds in the event of U.S. economic strength and its impact on duration. We are getting less worried, as argued above, and are examining long-dated bonds in high-rated liquid sovereigns (Mexico and Israel come to mind).

Everyone is talking about Argentina, and it remains a key holding (and therefore risk) in our portfolio. But let us start with some perspective – despite its recent default and the media focus, Argentina has been one of our best performers since the start of this year. First, most defaults are characterized by a debtor unwilling and/or unable to pay. This is not the case with Argentina, which is being prevented by U.S. court rulings from paying one series of bonds. Second, Argentina's argument is that it cannot negotiate (as per the U.S. court's orders), until the end of this year when a bond clause allows the government to do so. If this is the case, one is basically looking at the risk of a missed coupon for the remainder of the year, but not an ultimate unwillingness or inability to pay situation. Third, we believe that all candidates in next year's elections want to resolve the debt issue. Fourth, opening Argentina up to financing could be transformative, as a small amount of market access should take their credit spread to a different state. Fifth, based on the country's fundamentals, our framework indicates the credit spread should be substantially lower.

There are risks in Argentina, not least of which are the risks of further economic weakness, social instability, and potential new payment claims when/if other bonds subject to the U.S. court's ruling see their coupons coming due. We expect to see further economic weakness due to confidence related to Argentina's new default and due to the risks to financing. Moreover, in our view, the government's stance often seems ideological, given the risks it appears to be taking with the economy. Social unrest should also be expected, in our opinion, as Peronist institutions (particularly the Governors) want a debt deal to help improve their finances, and institutionalized social unrest is a frequent tool of communication from the provinces to the federal government.

Our allocation to Argentina reflects a core exposure to performing bonds (that are unaffected by U.S. court rulings), and we have a tactical stance towards the more volatile bonds that are directly affected by U.S. court rulings. We see Argentina as a significant idiosyncratic investment with what could be substantial upside over the next six months, for the reasons noted above. However we recognize it could be a bumpy road.

As a result, our core exposure reflects our near-term view and pays its coupons along the way, whereas our tactical exposure reflects our faster-changing view on Argentina's debt negotiations.

We will end with Russia, where we still see a deteriorating economy, bad bond market technicals, and a political conflict with Ukraine that may leave the U.S. with no obvious off-ramps. We have written extensively on this topic in the past so we'll just summarize. In our view, every "summit" has not met expectations because the domestic Ukrainian political dynamic is one of escalation and radicalization. Russia has been backed into a corner and the conflict is becoming existential for Vladimir Putin (who, among other things, fears the precedent of protest crowds overthrowing elected governments). The conflict can easily expand geographically, with Armenia, Latvia, Moldova, Romania, Bulgaria, Serbia, and, much less so, Hungary, all possible flashpoints. Finally, because Western sanctions have effectively prevented Russian entities from rolling over their debt, we do not understand the upside/downside argument for Russian bonds. We used to argue that 250 basis points over 5-year U.S. Treasuries is not enough upside for Gazprom debt when we see a 20-point price decline as a feasible year-end scenario and now we are arguing that 350 basis points over is not enough upside when we see an even likelier scenario of major point declines in Russian bonds.

Exposure Types and Significant Changes

Our top-5 positions are almost unchanged from last month, as we have been rebalancing the portfolio for several months already. They are currently Argentina, Peru, Brazil, Venezuela, and Indonesia.

Biggest Country- and Bond-Level Changes

- We increased Indonesia significantly, as a result of a likely resolution to election uncertainty. Resulting policy may be benign to positive in our view. Our corporate analyst returned, and we saw a few corporates that were always cheap, and with elections now out of the way, we are of the view that they may either benefit from, or not be punished by, new economic policy.
- We increased Peru, due to its ongoing fundamental improvements (our economist visited last month), which has been rewarded with ratings agency upgrades to its banking sector, specifically encouraging us to increase our bank exposure there.
- We reduced Israel, closing all of our local currency exposure. The currency hit our target, and recent rate cuts indicated a central bank comfortable with currency weakness after a long period of strength.
- We reduced our only long-dated exposure within our Venezuela position. We see Venezuela as cheap, but long-dated bonds could correlate poorly, and recent suggestions that the country may sell its Citgo assets likely generates short-term liquidity but raises longer-term risks.

Fund Performance

The Fund (EMBAX) gained 0.06%, compared to a 1.06% loss for the GBI-EM local-currency index and 0.40% gain for the EMBI hard-currency index. The Fund's biggest winners were India, Argentina, Brazil, and Vietnam, all in hard-currency. The Fund's biggest losers were positions in Brazil and Mexico that had higher correlation with global HY (high-yield) and Angola (due to links with the Banco Espirito Santo banking crisis in Portugal). Turning to the market's performance, the GBI-EM's biggest winners were Indonesia, Nigeria, and Thailand which were not as heavily owned due to previous political/policy concerns. The biggest losers were Russia (the on-going Russia-Ukraine conflict), Brazil (a less dovish central bank, local macroeconomic policy issues and concern about Brazilian Real outlook after the elections), and Hungary (a "bad" neighborhood, concerns about the impact of the government's Forex mortgage policy on local banks). The EMBI's biggest winners were Argentina, Belize, and Indonesia, and its biggest losers were Russia, Venezuela, and Mongolia.

Average Annual Total Returns (%) as of July 31, 2014

	1 Mo	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	0.06	9.76	12.08	7.55
Class A: Maximum 5.75% load	-5.65	3.47	5.59	4.51
GBI-EM Index	-1.06	4.87	3.39	--
EMBI Index	0.40	9.10	10.74	--

Average Annual Total Returns (%) as of June 30, 2014

	1 Mo	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	0.59	9.69	14.24	7.85
Class A: Maximum 5.75% load	-5.16	3.40	7.65	4.67
GBI-EM Index	1.00	5.99	3.91	--
EMBI Index	0.36	8.66	11.63	--

Data Source: Van Eck Research, Factset. All portfolio weightings and statements herein as of July 31, 2014. Unless otherwise indicated.

Expenses: Class A: Gross 1.42%; Net 1.25%. Expenses are capped contractually until 05/01/15 at 1.25% for Class A. Caps exclude certain expenses, such as interest. The tables above present past performance which is no guarantee of future results and which may be lower or higher than current performance. Returns reflect applicable fee waivers and/or expense reimbursements. Had the Fund incurred all expenses and fees, investment returns would have been reduced. Investment returns and Fund share values will fluctuate so that investors' shares, when redeemed, may be worth more or less than their original cost. Fund returns assume that dividends and capital gains distributions have been reinvested in the Fund at NAV. Index returns assume that dividends of the index constituents have been reinvested. Investing involves risk, including loss of principal; please see disclaimers on next page.

Please note that the information herein represents the opinion of the portfolio manager and these opinions may change at any time and from time to time.

Emerging Markets Hard Currency Bonds refers to bonds denominated in currencies that are generally widely accepted around the world (such as the U.S.-Dollar, Euro or Yen). **Emerging Markets Local Currency Bonds** are bonds denominated in the local currency of the issuer. **Emerging Markets Sovereign Bonds** are bonds issued by national governments of emerging countries in order to finance a country's growth. **Emerging Markets Quasi-Sovereign Bonds** are bonds issued by corporations domiciled in emerging countries that are either 100% government owned or whose debts are 100% government guaranteed. **Emerging Markets Corporate Bonds** are bonds issued by non-government owned corporations that are domiciled in emerging countries. A **Supranational** is an international organization, or union, whose members transcend national boundaries and share in the decision-making. Examples of supranationals are: World Bank, IMF, World Trade Organization.

Any indices listed are unmanaged indices and include the reinvestment of all dividends, but do not reflect the payment of transaction costs, advisory fees or expenses that are associated with an investment in the Fund. An index's performance is not illustrative of the Fund's performance. Indices are not securities in which investments can be made. The J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM) tracks local currency bonds issued by Emerging Markets governments. The index spans over 15 countries. The J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI) tracks returns for actively traded external debt instruments in emerging markets, and is also J.P. Morgan's most liquid U.S.-dollar emerging markets debt benchmark.

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Investors should consider the Fund's investment objective, risks, and charges and expenses carefully before investing. Bond and bond funds will decrease in value as interest rates rise. The prospectus and summary prospectus contain this as well as other information. Please read them carefully before investing. Please call 800.826.2333 or visit vaneck.com for performance information current to the most recent month end and for a free prospectus and summary prospectus.

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