

## Manager Commentary

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## Global Central Banks Set the Tone for 2015

By: Eric Fine, Portfolio Manager

## Executive Summary

- Key investment themes remain unchanged from year end
- We sold off our Venezuela position based on concerns about oil prices and inadequate reforms
- We continue to watch the Greek debt crisis and its potential to generate significant market swings

## Overview

The key themes that characterize our portfolio remain unchanged. We continue to prefer hard currency debt over local currency, with the exception of a small position in China offshore (our only local currency exposure). We have no Venezuela or Russia/Ukraine-related exposure. We remain comfortable with duration and prefer to express the view through exposure to selective, investment-grade liquid sovereign bonds, most of which are issued by net creditor countries. We continue to limit our exposure to corporate debt due to concerns about the “liquidity illusion” and correlation with the U.S. High Yield sector, and continue to have exposure to idiosyncratic bonds in Argentina and Vietnam.

We have maintained our stance despite several episodes of market volatility. Our views on Emerging Market (EM) currencies were seriously tested in January when the negative correlation between the U.S. dollar (USD) and EM currencies, which has historically been strong, broke down. Even though the USD continued to strengthen during the first half of the month, EM currencies’ overall performance was rather surprising during the same period. EM currencies either rallied or held up better than expected, or predicted, from the historical relationship between the two. Our EM foreign exchange (FX) valuation framework, however, indicated that most emerging currencies were overvalued on a short-term basis.

We remained cautious that the “quiet” period for EM currencies in early January might be short-lived for several reasons. First, the negative correlation between the USD and EM currencies tends to weaken during risk-on periods or periods of low global volatility. Second, there are multiple outstanding issues that can cause global volatility to spike (Fed policy normalization in conjunction with uneven U.S. macro data flow; noise in the Eurozone associated with Greece; and a potential escalation between Russia and Ukraine). Third, on a fundamental level, market consensus continued to downgrade EM real GDP growth relative to the U.S. in 2015, with the exception of Asia where we saw a marginal reduction in the growth expectations differential in January. Given these different circumstances, EM currencies’ outperformance did not make a lot of sense to us. We were finally vindicated later in the month.

Looking ahead, the Greek debt crisis and its impact on the country’s membership of the Eurozone and, potentially, of the European Union may generate significant market swings similar to what we saw in January. The newly elected Greek government appears to be at loggerheads with European officials over several key issues. The Greek side insists on the need to ease the country’s debt and fiscal burden and the reversal of several key reforms imposed by the “Troika” package and the “bridge” program in order to generate growth and meet its February-August debt payment “hump”. On the other hand, the European side insists that Greece must honor the promises made by the previous government and continue to implement far-reaching structural reforms. Greece does not have time for protracted negotiations as it faces approximately EUR30bn in debt payments between now and August. Meanwhile, any major concessions by Europe to the Syriza-led government might prop up similar political movements in other parts of the union, such as Spain and Portugal.

A potential escalation of the Russia/Ukraine conflict is another global “hot-spot” that is unlikely to be resolved soon. This is the main reason why we continue to have no Russia/Ukraine-related exposure in our portfolio. There are many moving parts with different degrees of transparency in the conflict. Russia’s economic situation is likely to worsen before it improves. In our view, the economy is likely to be in recession for at least two years. Headline inflation could potentially move to the high-teens in the coming months on the back of the Ruble weakness and a higher-than-expected foreign exchange pass-through. The only relative bright spot is that weaker domestic demand should prop up the current account surplus. However, the problem of the multiple uses of reserves is still valid; the government and many systemically-important companies and banks have virtually no access to the international financial markets. As such, the balance of risks in Russia is not attractive for us, at least for now.

Similar to Russia and Ukraine, we currently have no Venezuela exposure in our portfolio. Despite numerous promises to boost structural reform efforts, we are yet to see any coherent plan of reforms. The government’s recent move to introduce a supposedly more market-based FX system was a major disappointment. The political noise in the country remains very elevated and we are not convinced that the latest uptick in oil prices can be sustained over a longer term.

The recent macroeconomic data released in China continue to support the assumptions behind our local currency exposure in the country. Even though the 2014 real GDP growth number was in line with expectations, higher-frequency indicators (such as import growth) continue to signal an ongoing slowdown of domestic demand. The January Consumer Price Index (CPI) and Producer Price Index (PPI) numbers also surprised on the downside. The People’s Bank of China (PBoC) responded to the weak dataflow by further reducing the reserve requirement ratio (RRR). However, further easing might be needed if current trends persist.

We believe that the exchange rate risks in China are limited. The government seems mindful of the potential impact of sharp currency moves on local entities' ability to service their foreign exchange denominated debt. As such, any further expansion of the Chinese Yuan (CNY) daily trading band is likely to be gradual.

Our preference for hard currency-denominated debt over local currency-denominated debt is based on the expectation that EM growth is likely to continue to disappoint in 2015, and potentially in 2016. We also remain uncertain about commodity prices, which historically have been highly correlated with emerging markets currencies. Also, the net issuance plans for local currency-denominated debt in emerging markets seem weak in 2015; an added concern especially on the "technical" side.

Finally, we are still comfortable with duration and prefer to express this view by holding selective liquid, investment-grade quality sovereign bonds. Although there are multiple factors that support our current duration exposure (a sharp negative turn in the U.S. macroeconomic outlook, and low inflation pressure in the U.S. economy), duration remains a key risk to our portfolio. First, there is a large disconnect between expectations for the Fed Funds Target Rate implied by the Fed's forecasts, which are based on a complex economic construct, and the market, as seen in the Fed Funds Futures. An unexpected hawkish turn in the Fed's rhetoric might have a negative impact on duration. Second, we see the formation of a new global paradigm with stocks becoming near explicit price targets and quasi-monetary policy instruments. Set against this backdrop, there are a growing number of so-called "risk-free" bonds yielding less than 1%, with many at negative yields. This should make U.S. Treasuries look attractive; at a minimum we expect it will put upward pressure on the USD.

### Exposure Types and Significant Changes

The changes to our top five positions are summarized below. Our largest positions are currently: South Korea, Mexico, Argentina, the Philippines and Vietnam.

- We added exposure to higher-quality, long-duration bonds in South Korea, Mexico, and the Philippines. All three countries are net creditors, with public sector external debt below international reserves.
- We reduced exposure to Venezuela due to concerns about oil prices and inadequate reforms.

**Data Sources:** Van Eck Research, FactSet. All portfolio weightings and statements herein as of January 31, 2015. 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. Please note that, generally, unconstrained bond funds may have higher fees than core bond funds due to the specialized nature of their strategies. 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 call 800.826.2333 or visit vaneck.com for performance current to the most recent month ended.

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.

- We reduced exposure to hard currency corporate debt in China due to uncertainties associated with the domestic political scene.
- We reduced positions in Brazil, Colombia, Chile, Vietnam, and Argentina.

### Fund Performance

The Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) gained 1.47% in January, compared to a 0.34% gain for the J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM) local currency index and a 0.93% gain for the J.P. Morgan Emerging Markets Bond Index (EMBI) hard currency index. The Fund's biggest winners were Chile, Mexico and South Korea (all in hard-currency). The Fund's biggest losers were Venezuela, Colombia and Brazil.

Turning to the market's performance, the GBI-EM's biggest winners were Russia, Romania and Chile (with Russia benefitting from the higher oil price, and Romania and Chile benefitting from renewed easing expectations). The biggest losers were South Africa, the Philippines and India. The EMBI's biggest winners were Venezuela, Ukraine and Belarus, while its biggest losers were Belize, Namibia and Uruguay.

#### Average Annual Total Returns (%) as of January 31, 2015

	1 Mo	3 Mo	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	1.47	-3.11	1.47	5.41	3.55
Class A: Maximum 5.75% load	-4.38	-8.70	-4.38	-0.67	1.19
GBI-EM Index	0.34	-6.85	0.34	-0.81	--
EMBI Index	0.93	-1.32	0.93	9.17	--

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

	1 Mo	3 Mo	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	-4.57	-4.90	1.83	1.83	3.06
Class A: Maximum 5.75% load	-10.10	-10.34	-4.01	-4.01	0.64
GBI-EM Index	-5.93	-5.71	-5.72	-5.72	--
EMBI Index	-2.31	-0.55	7.43	7.43	--

**Duration** measures a bond's sensitivity to interest rate changes that reflects the change in a bond's price given a change in yield. This duration measure is appropriate for bonds with embedded options. **Quantitative Easing** by a central bank increases the money supply engaging in open market operations in an effort to promote increased lending and liquidity. **Monetary Easing** is an economic tool employed by a central bank to reduce interest rates and increase money supply in an effort to stimulate economic activity. **Correlation** is a statistical measure of how two variables move in relation to one other. **Liquidity Illusion** refers to the effect that an independent variable might have in the liquidity of a security as such variable fluctuates overtime.

**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 denominated 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. The **Consumer Price Index (CPI)** measures changes in the price level of a market basket of consumer goods and services purchased by households. The **Producer Price Index (PPI)** program measures the average change over time in the selling prices received by domestic producers for their output. The **reserve requirement ratio** is a regulation employed by a country's central bank that sets the minimum fraction of customer deposits and notes that each commercial bank must hold as reserves

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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](http://vaneck.com) for performance information current to the most recent month end and for a free prospectus and summary prospectus.

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Van Eck Securities Corporation, Distributor  
335 Madison Avenue | New York, NY 10017



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