Manager Commentary

Interest Rates Back in Focus in April

By: Eric Fine, Portfolio Manager

Executive Summary

- Due to fundamental and technical factors which we have been watching for the past few months, we adjusted our view on duration to negative.
- We increased our idiosyncratic sovereign and corporates exposures and added some selective local currency exposures.

Overview

During April, there were several changes in the broad themes that describe our portfolio. First, we became more selective on duration. Second, even though we continue to have concerns over most local currency debt due to a generally lukewarm growth outlook in emerging markets and low real interest rates, we are now more open to having exposure in idiosyncratic countries with high real interest rates or other advantages. Third, we remain vigilant in the corporate debt space due to concerns about illiquidity, currency mismatches and issuance, but we think that some high-grade bonds have value and some high-yield bonds appear to have priced in some risk. Even though some of our views underwent changes, two themes in our portfolio remained unchanged. We remain cautious on Russia due to high headline risks and potential downside risks if sanctions escalate further. We also remain comfortable with idiosyncratic exposure in Vietnam, Brazil, and Nigeria and we increased this exposure in April.

We have mentioned previously that duration remained a risk in the portfolio. In April, after analyzing a wide range of fundamental and technical factors, which we have been carefully watching for a few months, we adjusted our view on duration to negative. As a result, many of our long-dated holdings failed our vulnerability test. Some of the factors for this are as follows. First, there are signs that growth might be stabilizing and broadening from the U.S. to the Eurozone. Eurozone manufacturing and composite Purchasing Managers Indices (PMIs) performed extremely well in the first quarter and stayed firmly within expansion territory in April. Second, wide money supply in the Eurozone – which includes bank lending – is now expanding at a brisk pace. Monetary conditions in the Eurozone have loosened significantly in the past few months (in part due to a weaker Euro), paving the way for a brighter activity outlook in the region. Third, market-based inflation expectations in the G4 nations have picked up noticeably in the past weeks, with the increase most pronounced in the U.S. and the Eurozone. Fourth, it looks as if global commodity prices have found a floor and have started to firm. If this trend continues, the low base effect's impact on headline inflation may become more pronounced in the second half of the year. Finally, the labor markets are gradually tightening and we now see more positive signs on the wage growth front as well – both in the U.S. and in the Eurozone. In the U.S., the average unemployment duration has fallen by six weeks over the past year, the unemployment gap is practically closed (i.e., the actual unemployment rate is very close to the non-accelerating inflation rate of unemployment [NAIRU]), while real disposable income growth and employment costs are finally getting closer to pre-crisis levels.

Greater reservations about global duration are the main reason why we decided to reduce exposure to low-spread sovereigns like Poland, South Korea and Israel. We, however, continue to like high-rated sovereigns in general. Most of them are net creditors. They are also currently paying more in principal and interest then they borrow. Markets tend to be underweight this sector, preferring corporate exposure because it tends to give more spread. Our current solution is to have shorter-duration exposure to this group of countries.

Concerns about the growth outlook in many emerging markets and generally low real local interest rates are the main reason why we remain cautious on local currency debt. However, we see several idiosyncratic stories where real rates are high (e.g., Mexico, Brazil, and Uruguay) and where we believe the macro/policy flow is moving in the right direction, as in the aforementioned countries and also in Chile. In the case of Mexico, the reforms implemented in the past few years strengthen the case for a structural decline in inflation going forward. In Brazil, the cabinet appears focused on keeping the country's rating in the investment grade bracket and on fixing its fiscal accounts, which should help to contain the inflation pressures and reduce the need for monetary tightening down the road. In Chile, recovering copper prices have improved the outlook for both the Chilean Peso and disinflation. Real growth is picking up, but is unlikely to move to overheating territory any time soon. Both groups of factors signal higher real rates and no near-term policy rate hikes.

As mentioned, we increased our exposure to idiosyncratic sovereigns and corporates. The main reasons why we are keeping sovereign exposure to countries like Vietnam and Argentina are that: (a) they are gradually re-pricing, and (b) they are not big index holdings. We are cognizant, though, that in the case of Argentina, the proliferation of Argentina-only funds and a potential risk-off in emerging markets could challenge its idiosyncrasy, while China and emerging markets currency weakness could pressure the currency in Vietnam.

In the past month, we added exposure to a few more sovereigns – including Nigeria, Dominican Republic, Paraguay, and Venezuela – where attractive valuations are now supported by stronger macro/policy stories and an improved visibility in commodity prices.

Nigeria's case is particularly interesting because the success of the presidential and local elections has significantly reduced the political headwinds and we believe this should allow its strong credit fundamentals finally to shine through. On the corporate side, our preference is to look for shorter-dated corporate debt where illiquidity and other risks are priced in.

We also shifted our Brazil exposure from sovereign exposure and Petrobras (in USD; 6.6% of total net assets) to drillers and the Brazilian Real (BRL). As we pointed out earlier, the main reason for being more comfortable with local exposure in Brazil is the way the Levy government is tackling the existing macroeconomic challenges, which is reminiscent of how emerging markets governments successfully handled crises in the past. The government has an aggressive fiscal plan which looks to be getting broad political support. If the cabinet stays on course, we think the fiscal adjustment should help to contain inflation pressures, paving the way for eventual policy rate cuts, while a weaker BRL should help to improve external competitiveness and reduce the current account gap. During the latter part of the month, we tactically reduced our exposure to Petrobras, and purchased selected secured bonds of Petrobras service providers and drillship operators. As we expected, the company reported its full-year financial results on time, avoiding a technical default and a further downgrade. We retained positions in Petrobras that continued to provide attractive spreads. The secured bonds of Petrobras service providers that we purchased have benefitted from long-term contracts (beyond most bond maturities), are priced at or below current spot market rates, and have attractive covenants.

Country Exposures and Significant Changes

Our largest positions are currently: Brazil, Peru, South Korea, Vietnam, and Mexico. Significant changes in our portfolio are summarized below:

- We added sovereign hard currency exposure to Peru as we continue to like the country's small funding needs/solid net creditor status and the improving growth prospects (the fiscal package with lower taxes, robust consumption, etc.). We added sovereign hard currency exposure to Venezuela to reflect more confidence about commodity prices.

- We also added Chile shorter-duration sovereign and corporate hard currency exposure, as well as local currency exposure. The move is a reflection of greater confidence in China's growth prospects which affects copper, Chile's main export.

- We added local exposure in Uruguay and hard currency exposure in Nigeria. The increase in Nigeria's exposure was done around the time of the local elections, which went very smoothly, strengthening our earlier thesis about lower political risks in the country.

- We reduced hard currency exposure in Hungary on concerns about the Greek situation, which is becoming more binary. We also reduced sovereign hard currency exposure in Argentina due to greater concerns about the upcoming elections and the consequences for Argentina's macro/policy outlook.

- We reduced our low-spread corporate and sovereign exposure in Mexico and low-yielding sovereign duration exposure in Poland.

Fund Performance

The Unconstrained Emerging Markets Bond Fund ("the Fund", Class A shares excluding sales charge) gained 1.22% in April, compared to a 2.92% gain for the J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM) local currency index and a 1.63% gain for the J.P. Morgan Emerging Markets Bond Index (EMBI) hard currency index.

The Fund's biggest winners were Brazil, Mexico and Argentina in hard currency. The Fund's biggest losers were Chile, Korea and Israel, also in hard currency. Turning to the market's performance, the GBI-EM's biggest winners were Russia, Brazil and Colombia. The biggest losers were Turkey, India and Peru. The EMBI's biggest winners were Venezuela, Ukraine and Ecuador, while its biggest losers were Uruguay, Lithuania and Romania.

Average Annual Total Returns (%) as of April 30, 2015

	1 Mo	3 Mo	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	1.22	-1.47	-0.02	-4.37	2.69
Class A: Maximum 5.75% load	-4.61	-7.19	-5.78	-9.84	0.56
GBI-EM Index	2.92	-1.49	-1.16	-9.35	--
EMBI Index	1.63	2.72	3.68	6.06	--

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

	1 Mo	3 Mo	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	-1.62	-1.23	-1.23	-3.14	2.32
Class A: Maximum 5.75% load	-7.29	-6.92	-6.92	-8.68	0.13
GBI-EM Index	-2.98	-3.96	-3.96	-11.14	--
EMBI Index	0.22	2.01	2.01	5.65	--

Data Sources: Van Eck Research, FactSet. All portfolio weightings and statements herein as of April 30, 2015. Unless otherwise indicated.

Expenses: Class A: Gross 1.32%; Net 1.25%. Expenses are capped contractually until 05/01/16 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.

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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. **Purchasing Managers Index (PMI)** is an economic indicator of the health of the manufacturing sector derived from monthly surveys of private sector companies which emcompasses new orders, inventory levels, production, supplier deliveries and the employment environment. The **Federal Funds Target Rate** is the interest rate at which member depository institutions trade balances held at the Federal Reserve with each other. A **Holdouts Issue** in the fixed income asset class occurs when a bond issuing country or entity is in default or at the brink of default, and launches an exchange offer in an attempt to restructure its debt held by existing bond holding investors.

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. The **European Central Bank (ECB)** is the central bank for the euro and administers monetary policy of the Eurozone, which consists of 19 EU member states and is one of the largest currency areas in the world. The **Labor Market Conditions Index (LMCI)** is a dynamic factor model index that combines 19 labor market indicators to provide an assessment of overall labor market conditions. The **Employment Cost Index** tracks the changes in the costs of labor for businesses in the United States economy.

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.

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