Manager Commentary

Global Growth Trends Reinforce Hard-Currency Bonds Bias

By: Eric Fine, Portfolio Manager

Executive Summary

- Situation in Ukraine remains fluid and extremely confusing
- Default scare in Venezuela sends bond prices plunging and inverts the yield curve
- Death of Eduardo Campos, a key presidential candidate, changes Brazilian political landscape

Overview

Our main portfolio themes remain the same. We continue to prefer hard-currency denominated bonds over local-currency denominated bonds, want no investments with Russia-/Ukraine-related risk, and like a barbell of cheap high-yielders and high quality low-yielders.

Our choice to own hard-currency over local-currency is reinforced by the global growth trends. Even though the emerging markets' Purchasing Managers' Index (PMI) – on average – remains in expansionary territory, growth in many individual economies is below potential, with downside surprises and GDP forecasts for several large and systemically important economies – including Brazil, Mexico, Russia, South Africa and Turkey – continuing to be revised down. The latest batch of macroeconomic indicators for China was also underwhelming. Further, emerging markets (EM) import growth appears to be on a firm downward trend, raising concerns about the strength of domestic demand. Emerging markets also remain exposed to potential growth hiccups in the developed world through export connections. Under these circumstances, EM real policy rates appear to be too high and we doubt that local central banks will embark on a tightening spree any time soon and many of them, in our view, would prefer to see EM currencies weaker to boost growth.

The situation in Russia and Ukraine remains extremely confusing and prone to sudden military and political escalations. A somewhat positive development of the past few days has been the (tentative) ceasefire between Russia and Ukraine. However, the military situation on the ground remains very fluid and whether momentum could be on the rebels'/Russia's side or Ukraine's side may affect conditions for talks. In addition, there are political constraints on Ukraine's President Petro Poroshenko with regard to how far he can go with concessions between now and the parliamentary elections in late October. A notable – and worrisome – development of the past few weeks is that Moscow's official talk about the former Soviet republics has become more militant. It also looks like the ceasefire might not be enough to prevent the imposition of additional economic sanctions on Russia in the coming days and weeks, and this will likely have a further negative impact on the already weak Russian economy (especially on Russian companies' and banks' ability to roll over their debt). As such, the current upside/downside balance for Russia- and Ukraine-related assets continues to look very unattractive.

An important story was the default scare in Venezuela which sent bond prices plunging and inverted the yield curve. We nevertheless chose to keep Venezuela among our key portfolio positions. It is true that Venezuela's economic outlook remains precarious. We think, however, that the departure of Rafael Ramirez – the influential head of the government's economic team – did not materially change the country's outlook for the worse and that Mr. Ramirez's replacement, Minister of Finance Rodolfo Torres, may implement many of the structural moves that were previously expected, albeit within a different time frame. We feel that the government's awareness of what needs to be done is still there, even though the end of the public protests diminished the sense of urgency. We believe that the government should have enough cash flow to make the forthcoming debt payments and it looks like its willingness to pay is still strong. The implied default probabilities – especially at the short end of the curve – look too high and valuations have become more attractive relative to fundamentals.

Markets continue to digest a major change in Brazil's political landscape in the run up to the presidential elections on October 5 following the death of a key presidential candidate – Eduardo Campos – in a plane crash. This propelled his running mate – a former Minister of Ecology, Marina Silva – to a leading position in the presidential polls. Even though Ms. Silva's lead over the incumbent, Dilma Rousseff, has subsequently narrowed, she has a real chance of becoming Brazil's next president after winning in the second round. Despite this massive shift, we made almost no changes in our existing positions in Brazil as we believe they may perform well under both scenarios. If Ms. Silva wins and is able to control her ideological bias, she will likely be implementing some reforms. Even though these will initially be "low hanging fruits", and she will have to compromise in order to build support in the parliament, growth outlook and especially the investment climate in Brazil should improve. This could likely be a boon to our exposure in construction and engineering. The rest of our holdings are in the sectors that depend more on factors outside Brazil – such as China's demand for meat – and as such should be less dependent on a potential adverse election outcome (Ms. Rousseff's becoming president once again).

Last but not least, even though we continue to find it difficult to take a strong directional view on duration – especially in the U.S. – we see several factors that should keep interest rates anchored for now. There is no question that many areas of the U.S. economy have shown improvement – in particular if measured against post-crisis averages. However, the introduction of the Fed's new labor market metric – unveiled to the public in Jackson Hole in August – gives it an option to stay on hold for longer if it chooses. Our own version of this metric explains why. Even though the so-called labor market slack has diminished significantly since 2009, several indicators – the labor participation rate, the share of discouraged workers and involuntary part-time employees – remain very far from the "neutral" levels (the pre-crisis multi-year averages). Further, money velocity continues to decline and pretty much all measures of inflation expectation in the U.S. are either stable (at low levels) or sliding down. Finally, growing geopolitical risk from an escalating conflict between the U.S. and Russia provides a risk-off bid to U.S. Treasury duration. Summing up, the Fed is moving closer to the first hike, but we do not expect it to happen before Q3-2015 (unless there is a meaningful change in the aforementioned trends).

Exposure Types and Significant Changes

There were changes in our top five positions in August as we continued rebalancing the portfolio. Our top five country positions are currently Brazil, Indonesia, Mexico, Peru and Venezuela.

Biggest Country- and Bond-Level Changes

- Our largest increase was in Mexico. The implementation of energy reforms in the country – including the secondary legislation – went smoothly and the economy should start benefitting from them in 2015. The latest rounds of the data releases have been encouraging and the growth outlook is now stronger.
- We also increased our hard-currency duration exposure in Israel for fundamental reasons.
- We increased our position in Indonesia. The noise surrounding the presidential elections is now behind us. We will, however, be closely watching the implementation of structural reforms, as well as potential risks associated with lower commodity prices.
- We reduced Argentina because of uncertainty around the settlement with holdouts and likely delays in the implementation of necessary reforms.
- We also reduced our position in Peru where concerns about the growth outlook and the impact of lower commodity prices on the current account balance resurfaced again.

Fund Performance

The Fund (EMBAX) gained 0.14% in August, compared to 0.48% for the GBI-EM local-currency index and 0.84% for the EMBI hard-currency index. The Fund's biggest winners were Mexico, Indonesia and Israel, all in hard-currency. The Fund's biggest losers were Argentina and Venezuela, as well as a small position in Russia.

Turning to the market's performance, the GBI-EM's biggest winners were Brazil, South Africa and Mexico, where markets reversed earlier exposure reductions. The biggest losers were Russia, Chile and Hungary. The EMBI's biggest winners were Ecuador, Belize and Uruguay, and its biggest losers were Argentina, Ukraine and Venezuela where negative idiosyncratic factors dominated in August.

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

	1 Mo	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	0.14	9.91	15.84	7.30
Class A: Maximum 5.75% load	-5.61	3.61	9.15	4.39
GBI-EM Index	0.48	5.38	8.32	--
EMBI Index	0.84	10.02	14.61	--

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 August 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. 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.

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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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