Manager Commentary

Emerging Market Debt Awaits China's Currency Movement

By: Eric Fine, Portfolio Manager

Executive Summary

- Portfolio defensively positioned with a focus on idiosyncrasy, liquidity, and de-risked assets
- Impact of China currency devaluation remains a concern
- Significant reduction in exposure to Venezuela

Overview

There are no big changes in our general views: We remain cautious overall on emerging markets debt and believe we are defensively positioned through a diversified portfolio consisting mostly of sovereign or quasi-sovereign, U.S. dollar-denominated, and high-rated debt.

Why cautious on emerging markets debt overall? First, China, particularly its currency, remains a concern. We have nothing new to say on this topic, so we'll just summarize our concerns. Leverage is high and rising, with ongoing deflationary pressures. The authorities have more or less telegraphed the need for currency devaluation, just not today. Nor tomorrow. The currency forward market has a benign outcome priced in; a smooth, linear, and not large devaluation is priced in, so obviously the concern should be over a discontinuous adjustment (i.e., if markets priced in a discontinuous move, worrying about one would be pointless). Second, emerging markets local currencies still pay low real interest rates, with no obvious bottoming in the growth dynamic. Third, emerging markets have re-levered since the U.S. financial crisis, with the Federal Reserve (Fed) poised to hike rates further. This is worth underlining, because the market continues to have a benign view on Fed rate hikes. Just as 2015 was characterized by tension in a market that said the Fed would hike later than the Fed's "dots" said it would (and the "dots" won), so we are in the same situation today. The market is saying 70bps in hikes in 2016, while the Fed's "dots" are saying 100bps. Look at what that battle has already done to U.S. rates and the dollar. Fourth, emerging markets corporates are vulnerable in the event of outflows, and outflows are implied by the above. The risk in corporates, in our opinion, is their illiquidity. So far, this illiquidity has been pronounced only in specific names (e.g., Petrobras), or sectors (e.g., oil, copper), due to an idiosyncratic trigger. When bonds were sold, prices generally saw significant downside. However, emerging markets corporates didn't suffer because there weren't generalized triggers for the entire asset class.

In what way are we defensively positioned? (1) No local; (2) Limited corporate exposure; (3) Focus on de-risked positions; (4) Focus on liquidity; (5) Idiosyncratic diversifiers; (6) Safe haven performers; (7) Cash allocation; and (8) Reducing Venezuela exposure. We look as some of these below:

No local: First, real interest rates in emerging markets remain low, despite historically low inflation in many countries. Second, the growth outlook for emerging markets is uncertain, with consensus growth forecasts for 2016 continuously revised down. Meanwhile, the expected growth differential between emerging markets and developed markets (as well as between emerging markets and the U.S.) – a key source of fundamental support for emerging markets currencies – continues to narrow. Third, a lack of recovery in commodity prices will continue to undermine both emerging markets growth and emerging markets currencies going forward. Fourth, even though the current accounts continue to improve in many emerging economies (largely as a result of weaker imports), inflows on the capital account side are often smaller and are likely to decline further as the Fed continues to withdraw liquidity. So, the overall balance of payments story in emerging markets is becoming less supportive of emerging markets currencies. Finally, several large and systemically important emerging markets countries (e.g., Turkey, China, and Brazil) remain at risk of some type of crisis that might result in regional, or even global, spillovers. Rating downgrades in China (which would raise the cost of capital, presumably), most importantly, would not surprise us.

Find de-risked asset prices: We continue to focus on positions that have already de-risked. Russia and Brazil (in USD) fit this description, and we could see larger allocations there. In Russia, sanctions have dampened investor exposure, but the economy is proving resilient and authorities opted for a more orthodox policy response than initially expected, allowing the currency to act as a shock-absorber. And it is working! The ruble has sold off almost 75% in the past year. And inflation at the end of this year could be a measly 7%! Russia continued to pay its debts, despite having its market access severely restricted under sanctions. As a result, the government's external debt has halved in the past two years (falling to $31.8bn). In Brazil, the corruption scandal and the deteriorating macro story have similarly pressured investor exposure. Though we don't expect any "resolution" soon, and we see the currency and other asset prices as vulnerable, we do not see this mapping to sovereign U.S. dollar debt, to which we have exposure. Brazil is a net creditor and actively buys back its debt. Investors have de-risked, in our opinion, due to downgrades to below-investment grade. In fact, we see an underweight actual position in the market, but an overweight position as the "mental" position.

Focus on liquidity: The investment team does its own trading, which we believe is a special advantage right now as today's "liquidity" is not tomorrow's. We always focus on liquidity, but are trying to make sure that potentially illiquid bonds are not in the portfolio. We sometimes get asked about our portfolio's higher turnover (and we are happy to provide data showing, we think, that our turnover is surprisingly not costly), but our point is that if liquidity is a concern, portfolios that can turn themselves around quickly are a potential answer.

Idiosyncratic diversifiers: Argentina (and Brazil, which we've already discussed above) is our main idiosyncratic diversifier, to which we've had significant exposure for the past three years. Argentina's new government is likely to deal with the so-called "holdouts" from the 2001 debt default in the coming months and this will result in a one-off payment of past-due interest on bonds we own, equal to roughly 150 bps of assets under management (in addition to a likely rating upgrade to single-'B'). These negotiations do not correlate with global systematic factors such as oil prices, the stock market, etc. Meanwhile, we feel the new government's line-up was impressive – including the new central bank governor – and President Mauricio Macri was able to deliver on his ambitious promise to liberalize the official exchange rate sooner than expected. Notably, the Argentine peso remained remarkably stable after the initial 35% move on December 17th. We expect a number of positive, catalyzing events such as rating upgrades, swap lines with international banks, new investment, and, of course, a resolution of the "holdout" issue that are self-evidently idiosyncratic.

Safe haven performers: The main benefit of having our significant Korean exposure in the current unstable environment is that it empirically trades well in risk-off. The country is high-rated and its willingness to pay is, in our view, practically beyond doubt. As an extra bonus, Korea's current account surplus is among the highest in the world (7.84% of GDP in the third quarter of 2015) and keeps widening. Meanwhile, Korea's activity indicators (manufacturing PMI [purchasing managers' index], retail sales, and inflation) finally started to look a bit more resilient.

Cash allocation: We want flexibility and the opportunity to buy in the event of any overreaction in market prices.

Reducing Venezuela exposure: An important change that we made in our portfolio in December was a significant reduction of our exposure in Venezuela. The reasons are two-fold. First, after convincingly winning the elections the opposition appears to be focused more on getting rid of President Nicolás Maduro, rather than on economic issues (especially currency floatation) – and this means uncertainty. Second, given the policy uncertainty, the price action in the run-up to the elections and in the middle of the month did not look sustainable to us – hence our decision to take profit and minimize the position. We were able to reverse our losses for the year because of the election result. However, due to the opposition's postponement of a focus on the economy (it is focusing on getting rid of President Maduro), we will wait before we revisit our exposure.

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions are currently: Argentina, South Korea, and Mexico (all positions in USD sovereign or quasi-sovereign).

- We reduced Venezuela hard-currency sovereign dollar debt because we believe that the opposition (which just won elections to the National Assembly) will focus on removing President Maduro rather than on changing economic policy (by which we basically mean allowing the currency to float).
- We also reduced South Africa hard-currency sovereign and quasi-sovereign debt, as President Zuma dismissed his Finance Minister in a surprise move that pointed toward a much more unorthodox policy. South African fiscal policy has historically been a key anchor for the country, and this was jeopardized by that move.
- We reduced Colombia dollar sovereign debt due to our view that those bonds would correlate to declining oil prices.
- We increased Brazil dollar sovereign bonds. We expect local buying of these bonds as a safe haven relative to local currency. Also, foreign investors have already greatly reduced their exposures.
- We also increased Slovenia sovereign dollar-denominated bonds. They are trading wide to their euro-denominated bonds on an asset-swapped basis, and we see a chance of a liability management operation (namely swap more expensive dollar bonds for cheaper euro bonds). We also see stable fundamentals in a world searching for safe havens.
- We invested in Pakistan dollar sovereign bonds. Their economy is growing, external accounts are strong, relationships with international financial institutions are strong, and the bonds are not a significant part of indices (and thus less vulnerable in the event of outflow-driven selling from index-sensitive bond funds).

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Fund Performance

The Fund (EMBAX) declined 1.99% in December, compared to a 1.81% loss for a 50% local-50% hard-currency index.

The Fund's biggest winners were Argentina, Brazil, and Pakistan (all hard-currency sovereign with some hard-currency quasi-sovereign in Argentina). The Fund's biggest losers were Venezuela (dollar sovereign), South Africa (dollar quasi-sovereign and sovereign), and Russia (dollar sovereign and quasi-sovereign).

Turning to the market's performance, the GBI-EM's biggest winners were Nigeria, Poland, and India. The biggest losers were South Africa, Russia, and Mexico.

The EMBI's biggest winners were Argentina, Lebanon, and Egypt, while its biggest losers were Zambia, Gabon, and Iraq.

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

	1 Mo	3 Mo	YTD	1 Yr	3 Yr	Life
Class A: NAV (Inception 7/9/12)	-1.99	1.03	-13.60	-13.60	-5.71	-2.03
Class A: Maximum 5.75% Load	-7.68	-4.81	-18.57	-18.57	-7.54	-3.68
50% GBI-EM GD/50% EMBI GD	-1.81	0.63	-7.14	-7.14	-4.58	-

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

	1 Mo	3 Mo	YTD	1 Yr	3 Yr	Life
Class A: NAV (Inception 7/9/12)	-3.71	-10.61	-14.47	-18.67	-4.15	-2.49
Class A: Maximum 5.75% Load	-9.29	-15.78	-19.40	-23.32	-6.02	-4.26
50% GBI-EM GD/50% EMBI GD	-2.13	-6.19	-7.72	-10.62	-3.69	-

Diversification does not assure a profit or prevent against a loss.

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 Net Asset Value (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.

Data Sources: Van Eck Research, FactSet. All portfolio weightings and statements herein as of December 31, 2015. Unless otherwise indicated.

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. 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.

All indices are unmanaged 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 50/50 benchmark (the "Index") is a blended index consisting of 50% J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified and 50% J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM). 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. J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified 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 J.P. Morgan Emerging Country Currency Index (EMCI) is a tradable benchmark for emerging markets currencies versus the U.S. Dollar (USD). The Index compromises 10 currencies: BRL, CLP, CNH, HUF, INR, MXN, RUB, SGD, TRY and ZAR. The Consumer Confidence Index (CCI) is an indicator designed to measure consumer confidence, which is defined as the degree of optimism on the state of the economy that consumers are expressing through their activities of savings and spending.

Investing involves risk, including loss of principal. You can lose money by investing in the Fund. Any investment in the Fund should be part of an overall investment program, not a complete program. The Fund is subject to risks associated with its investments in emerging markets securities. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. As the Fund may invest in securities denominated in foreign currencies and some of the income received by the Fund will be in foreign currencies, changes in currency exchange rates may negatively impact the Fund's return. Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. The Fund may also be subject to credit risk, interest rate risk, sovereign debt risk, tax risk, non-diversification risk and risks associated with non-investment grade securities. Please see the prospectus and summary prospectus for information on these and other risk considerations.

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.