VanEck™

VanEck FUNDS

Likely Dovishness in U.S. Bodes Well for Emerging Markets

By Eric Fine, Portfolio Manager

VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

There has been no change in our assessment of the global economic environment, which remains fragile and buffeted by persistent headwinds. It is currently not clear how certain it is that the bicycle will fall over, or, to extend the metaphor, whether it will fall over on the left side or the right side. But our view is that there are clear fragilities combined with headwinds.

First, China's imbalances remain unresolved – even though this issue seems to be "forgotten" by the market right now. On the fundamental side, the key set of concerns is that the scale of leverage is very high, the rapidly increasing supply of money relative to production, as measured by the M2/GDP ratio (210% in March 2016), is generating an ever-decreasing number of marginal output units, while rising unit labor costs are undermining China's external competitiveness. The latest data releases also suggest that the initial "bump" to China's activity indicators from an earlier policy stimulus is waning – both official and Caixin Purchasing Managers' Indexes (PMIs) eased in April and May, with the value added of industry, retail sales and fixed assets investment growth doing the same in April. These numbers are concerning given that China is expected to make a significant contribution to global economic growth. The recent stabilization of China's international reserves is undoubtedly a welcome development. However, a lack of transparency about the People's Bank of China's (PBoC) forward operations makes it difficult to say with certainty that the level of the official reserves reflects the actual state of affairs with regards to the exchange market pressures.

Second, the macro data flow in the U.S. is mixed and the prospects for the Federal Reserve's (the Fed) policy normalization are uncertain. On one hand, the wage growth seems to be picking up (the Atlanta Fed Wage Growth Tracker, a measure of the wage growth of individuals constructed using the median percent change in the hourly wage of individuals observed 12 months apart, was up 3.4% year over year in April), the industrial output growth and capacity utilization appear to be bottoming out, the University of Michigan sentiment indices are rebounding, and Q2 GDP growth expectations are close to 2.5%. On the other hand, the manufacturing and services PMIs are rapidly converging to 50 (readings below 50 signal a contraction), market-based inflation expectations remain below the previous highs, and the recent weak labor market releases are hardly awesome news. It is not surprising that market expectations regarding the Fed's next move are jumpy, with the latest round of revisions pushing the rate hike possibly back to December 2016.

It remains to be seen whether the Fed would be as dovish as markets currently expect, but one thing is certain - we currently live in a dovish world where other developed markets' central banks are unlikely to start normalizing any time soon. Given that easing programs in advanced economies pushed the savings rates up and potential output down, the dovishness is unlikely to disappear any time soon. One consequence of this vicious policy circle is that a very large portion of global nominal bonds now has negative yields often making emerging markets debt look more attractive in comparison.

Over the many years in which extreme monetary forbearance has been in place, emerging markets foreign currencies and commodities have generally underperformed, and new bouts of forbearance of the sort seems to be expected by the market now and have only provided short-term boosts to asset prices as a result of the weak payrolls report. Moreover, market participants are now alerted to the limits of easy monetary policy, namely that very low interest rates appear to encourage savings and hoarding, which was not the case at the earliest stages of the global monetary experimentation.

Third, there is Europe with its Brexit vote (the "leave" option momentum is gaining speed once again) and other economic and political challenges (Greece, banks, another wave of the migration crisis this summer, etc.). Against this challenging background, Europe's growth outlook remains underwhelming (the Eurozone's growth surprise index is still trending down, Germany's ZEW expectations sub-index is at a three-year low) and headline inflation still remains below zero despite the recent uptick in commodity prices and another round of quantitative easing.

Fourth, despite the recent tentative uptick in the emerging markets growth surprise index, question marks surrounding the emerging markets growth outlook abound (with China at the forefront). This uncertainty feeds into the market's skepticism about emerging markets governments' ability to stay fiscally prudent – consensus now expects the 2016 fiscal deficit in emerging markets to exceed 4% of GDP. A combination of weaker economic growth and larger fiscal gaps often paves the way for further rating downgrades, even though several key emerging markets countries – including Colombia and South Africa – have dodged the rating bullet for now. This risk will likely continue to affect the outlook for emerging markets debt going forward.

The tailwinds are still present, albeit many are fading or have ambiguous longer-term consequences. One observation is that emerging markets growth surprises seem to be less disappointing than those in the developed markets. In particular, the rising liquidity in China – for now – limits any potential growth downside. Further, the stabilization of China's international reserves have calmed down foreign exchange markets, temporarily mitigating a threat of large CNY devaluation that would undoubtedly have a profound impact on the rest of the emerging markets currencies. With this risk now pushed further into the future, many emerging economies can enjoy lower inflation pressures and an opportunity to maintain easier policy stances to support growth.

The asset price implications of this uncertain environment are complicated, but, as a fully unconstrained fund, we think we are uniquely positioned to take advantage of it. First, we continue to remain nimble and liquid. Second, we are aware of the resurgent headwinds and have a reaction function. Third, we respect tailwinds in downturns – big and long rallies often happen when things are bad. With this in mind, we prefer exposure to short-dated USD-denominated risk – in both sovereigns and corporates. We also like a combination of high spread/idiosyncrasy (Brazil, Argentina, Indonesia, Russia, Brazil corporates) and low spread that should outperform if the headwinds manifest themselves (South Korea, Mexico corporates). We will also, tactically, have local market exposure, but, as of now, only when there are over-reactions on the downside, or when we believe monetary forbearance from the Fed will produce a serious (however temporary) boost. At present, we do not expect any big long-term opportunity in emerging markets local currency debt, with the exception of Argentina.

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions are currently: Brazil, Argentina, Mexico, South Korea, and Indonesia.

- We added local currency sovereign exposure in Russia, Argentina and Malaysia. First, the inflation momentum in all these countries is improving (Russia and Argentina) or well under control (Malaysia). The central bank in Argentina also started to cut interest rates and Russia might follow suit soon. Also, in Russia and Malaysia, the currencies have lagged commodity prices, giving them good correlation scores in our investment process.

- We added sovereign hard currency exposure in Ukraine, Argentina and Indonesia, expecting to benefit from policy improvements and the resulting foreign currency inflows (Ukraine and Argentina) and higher commodity prices. We also added corporate hard currency exposure in Argentina and Russia (quasi-sovereign). In Ukraine, we see a high degree of idiosyncrasy given the depth of U.S./International Monetary Fund (IMF) support, giving the country favorable vulnerability scores in our investment process.

- We reduced hard currency sovereign exposure in South Korea, Chile and the Philippines which we used as funders for other positions in the portfolio.

- We also reduced local currency and hard currency sovereign exposure in Brazil and hard currency sovereign exposure in Turkey, due to concerns about the potential impact of the political noise on these credits.

Fund Performance

The Fund (EMBAX) lost 0.65% in May, compared to a loss of 2.81% for the blended benchmark 50/50 GBI-EM GD local-currency index and EMBI GD hard-currency index.

The Fund's biggest winners were Argentina, South Korea and Ukraine. The Fund's biggest losers were Brazil, South Africa and Indonesia.

Turning to the market's performance, the GBI-EM GD's biggest winners were the Philippines, India and China, while its biggest losers were South Africa, Mexico and Colombia.

The EMBI GD's biggest winners were Ecuador, Iraq and Ghana, while its biggest losers were Gabon, Egypt and El Salvador.

Average Annual Total Returns (%) as of May 31, 2016

	1 Mo†	3 Mo†	YTD	1 Yr	3 Yr	Life
Class A: NAV (Inception 7/9/12)	-0.65	3.92	4.81	-7.51	-4.31	-0.62
Class A: Maximum 5.75% Load	-6.33	-2.10	-1.28	-12.80	-6.18	-2.12
50 GBI-EM GD / 50% EMBI GD	-2.81	5.42	7.27	-0.14	-1.30	-

Average Annual Total Returns (%) as of March 31, 2016

	1 Mo†	3 Mo†	YTD	1 Yr	3 Yr	Life
Class A: NAV (Inception 7/9/12)	3.27	4.16	4.16	-8.88	-5.32	-0.82
Class A: Maximum 5.75% Load	-2.71	-1.90	-1.90	-14.13	-7.17	-2.38
50 GBI-EM GD / 50% EMBI GD	6.16	8.03	8.03	1.33	-1.70	-

†Monthly returns are not annualized.

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.

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

Expenses: Class A: Gross 1.44%; Net 1.25%. Expenses are capped contractually until 05/01/17 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.

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.

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 GD) Global Diversified and 50% J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM GD). The J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM GD) 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.