Manager Commentary

Emerging Markets Debt Continues to Move Higher

By: Eric Fine, Portfolio Manager

Executive Summary

- European Central Bank (ECB) deposit rate remains negative
- Federal Reserves's (Fed) communications still seem increasingly at odds with strengthening U.S. data
- The ECB's easing and the Fed's dovish communications could still point to emerging markets foreign exchange strength

Overview

There are no changes in our basic stance. We continue to prefer hard-currency denominated bonds over local-currency denominated bonds, and want no investments with Russia-/Ukraine-related risk. Also, a barbell of high- and low-yielders remains one of the best ways to describe our portfolio. The biggest potential upcoming change to the global landscape is any move toward higher rates in the U.S., which we'll discuss in a bit more detail. In any case, most of what you will read below can also be found in last month's commentary.

Let's start with the new global developments at the ECB and Fed, and what they could mean. (We won't mention China's property story anymore, as it seems to be a rather common story.) The first news is that the ECB moved to a negative deposit rate in the face of continuing demand weakness, and a view that inflation pressures are benign. In our view, a key effect of this remains that it represents a revolution in central bank thinking and behavior; only Denmark has made such a move. If one reserve-currency central bank (the Fed) uses money quantity as a tool, and the other reserve-currency central bank (the ECB) eliminates the zero percent floor for interest rates, then everything is now theoretically on the table in terms of future responses by all central banking authorities. More specifically, though, the Fed's quantitative tools effectively anchored the long-end of bond curves, and now the ECB's tool should anchor the front-end, perhaps for several years. Anchoring the front end is different and important, as it means actual derivative contracts and bonds may roll down to an even lower rate in a certain time horizon. In short, the ECB's move may be good for global bonds and for duration.

The Fed's communications seem increasingly at odds with strengthening U.S. data. The bond market's rally and sell-off (the 10-year Treasury yield rallied by roughly 30 basis points from its April high, and then gave almost all of it back in the first week of June) are testament to this. We see this tension as likely to persist, because the longer it continues, the closer we could get to a mature economic recovery set to turn downward. In particular, if the Fed waits long enough, historically normal recoveries point to an eventual downturn that may make tightening discussions problematic. Related to this, if the Fed does begin to tighten (or rather, communicate in that direction), it may mark a major change in what we believe is the most important determinant of all asset prices, and any resultant adverse feedback (for example, weaker confidence and real estate prices) may put downward pressure on longer-term yields, and even risks backfiring completely. (More on that some other day.) Anyway, in our opinion, this tension is likely positive for the U.S. dollar over the Euro, and points to volatility for duration.

The ECB's easing and the Fed's dovish communications could point to emerging markets currencies (EMFX) strength, challenging our view of owning hard-currency over local-currency. The ECB seems to be forcing savers out of cash and investors out of the front-end of the yield curve into anything else. The Fed has already done this, but is saying it could continue to do so. This combination typically points to a major risk-on trade, and EMFX and other risk trades behaved accordingly in the days surrounding these developments.

Given this, why are we sticking with our hard-over-local view? We should emphasize that our view on emerging markets (EM) local-currency is based on bottom-up analysis of each country, and the above is only saying that there may be some top-down challenge to our view. Most importantly, when we look at the major EM local-currency markets, we remain concerned. Russia, Brazil, Turkey, South Africa and Indonesia can all be characterized as having problematic inflation and weak growth. This means they are in a potential corner in which a weak currency addresses the growth dynamic, while interest rate policy needs to remain tight. Given our view that flows into and out of EM local-currency were central to last year's sell-off, the fact that the countries that dominate the indices can be characterized this way should be underlined.

In addition, we continue to worry about the EM growth outlook and continued inflation pressures, particularly from the food price component (which has the added risk of social instability). The recent growth disappointment in Mexico (the only major local-currency market we didn't mention as problematic above), caused its central bank to implement a surprise interest-rate cut, hitting the peso, for example. The charts on page 3 highlight our concerns on EM growth and inflation. Data released during the past month in Brazil underline this concern.

Another risk to our positioning is that we may be wrong on our "no Russia" view over the coming weeks or months. Russia's quasi-sovereign bonds (such as Gazprom) appear cheap on our models. (They fail our investment process, though, as the initial models are subject to subjective tests such as political risks.) Moreover, following the election of Ukraine's new president, there is some momentum for broader powers such as Russia, the U.S., and Brussels to contain/stabilize the low-level civil war. As this is happening, the International Monetary Fund (IMF) is likely to provide liquidity, regardless of the economic logic. Finally, the market seems underweight, providing potential trading support.

Why are we sticking with our no Russia-/Ukraine-related risk view? We continue to believe that looking at the situation from the top-down, the 'What will Putin or Obama do?' perspective, is wrong, and that in general it should be viewed from the bottom-up, Ukrainian, perspective. To us, this situation is still best characterized as one of radicalization and escalation. For example, even following the election, the Kiev government escalated its attacks on Eastern enemies, despite Russian recognition of the election result. Unfortunately, we've been able to provide such examples in our monthly commentaries at every juncture at which a potential stabilization appeared to be settling in. Moreover, we believe that the upside/downside in Russian (and Ukrainian) bonds makes no sense if this framework is correct. Essentially, the upside is the spread (230 basis points over U.S. Treasuries for a five-year credit default swap in Gazprom) with some compression potential. The downside is renewed sanctions that cause the bonds to trade on a price basis. We believe that the market has reacted to this by being underweight. We are reacting by having no allocation.

Exposure Types and Significant Changes

Our top five positions are almost unchanged from last month, as we've been rebalancing the portfolio for several months already. They are currently Venezuela, Brazil, Argentina, Mexico, and Israel.

Biggest Country- and Bond-Level Changes

- We increased our position in Argentina to 12.4% of assets under management from around 6%. After an adverse ruling by the U.S. Supreme Court, backing up holdouts in Argentina's 2001 sovereign default, the Argentine government initially indicated that it wouldn't negotiate, effectively cutting the capital-starved country off from markets. The government relented just a day later as it realized how catastrophic (economically and politically) it would be not to negotiate. Negotiations have, essentially, begun, and with them the natural back-and-forth brinksmanship. In our view, we expect an eventual deal, but we also expect market weakness to be a key prod to both parties as we enter the July 30 end of the grace period for its first defaulted sovereign bond.
- We also increased our position in India to 3.1% from no exposure at all. Here, we re-established a position in a corporate that we had exited due to election concerns that did not materialize. We met with company management and believe our bonds are cheap and may be viewed as such by the market as the company's executives continue to tour global capital markets.
- We reduced United Arab Emirates, Dominican Republic, and Mexico exposure, all because these long-dated bonds approached price targets. And because these targets were being reached on long-dated bonds that were especially vulnerable in the event of any eventual sell-off in duration.

Fund Performance

The Fund (EMBAX) gained 0.59% in June, compared to 1.00% for the GBI-EM local-currency index and 0.36% for the EMBI hard-currency index. The Fund's biggest winners were Venezuela and Brazil in hard-currency and Israel in both local-currency and hard-currency. The Fund's biggest losers were positions in Argentina, Indonesia, and Uruguay.

Turning to the market's performance, the GBI-EM's biggest winners were Russia, Nigeria, and Romania, names to which the market had substantially reduced exposure. The biggest losers were Indonesia, India, and Hungary. The EMBI's biggest winners were Argentina, Venezuela, and Ukraine, and its biggest losers were Iraq, Mongolia, and Philippines.

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	--

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

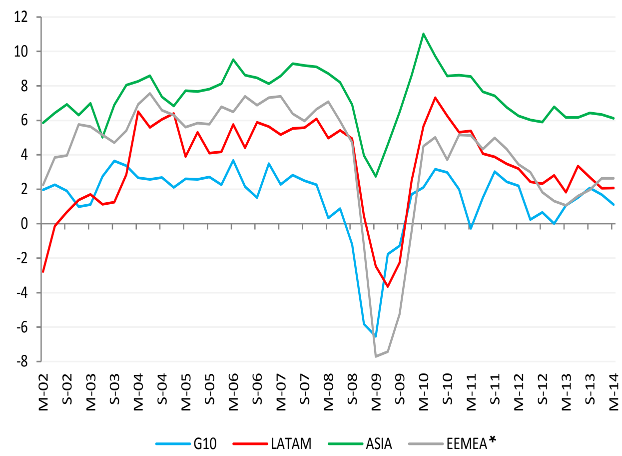
	1 Mo*	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	2.57	3.84	-3.83	5.62
Class A: Maximum 5.75% load	-3.31	-2.12	-9.35	2.07
GBI-EM Index	2.81	1.90	-7.14	--
EMBI Index	1.37	3.73	0.56	--

Data Source: Van Eck Research, Factset. All portfolio weightings and statements herein as of June 30, 2014. Unless otherwise indicated.

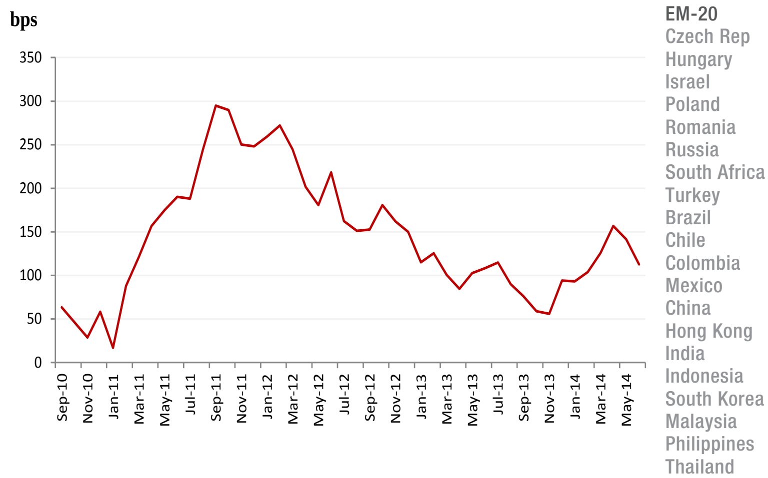
Expenses: Class A: Gross 1.42%; Net 1.25%. Expenses are capped contractually until 05/01/15 at 1.25% for Class A. Caps exclude certain expenses, such as interest. The tables above present past performance which is no guarantee of future results and which may be lower or higher than current performance. 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 investor's 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 in the index have been reinvested. Investing involves risk, including loss of principal; please see disclaimers on next page.

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.

Real Gross Domestic Product Growth (% year-over-year)



Real 10-year Local Yield Differential between EM-20 and U.S.



Source (both charts): Van Eck Global; Bloomberg. Data as of May 31, 2014.
These charts are for illustrative purposes only. Historical information is not indicative of future results; current data may differ from data quoted.

*EEMEA stands for Eastern Europe, Middle East, and Africa.

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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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.

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