Manager Commentary

Is a Buying Opportunity Brewing in Emerging Markets Debt?

By: Eric Fine, Portfolio Manager

Overview

We believe that a buying opportunity is brewing in emerging market debt, and already exists in Brazilian domestic debt. We expect that Brazil will be the first test case of the resilience of the asset class since its recent buffeting from rising U.S. yields and a stronger dollar.

Below, we review the case for idiosyncratic emerging market debt, and see Brazil as the bandleader for the market in the foreseeable future. We still see many emerging markets as being in serious trouble, with, in our opinion, Malaysia, India, and Turkey among the more vulnerable. However, our response is to not own these three, rather than avoid emerging market risk generally.

Recent interest rate hikes and currency interventions in Brazil represent in our opinion the key test case of how emerging markets' generally stronger balance sheets (i.e., lower debts and deficits) may respond to "good" monetary policy.

One of the key arguments behind emerging market debt has been its stronger fundamentals relative to developed market debt. "Fundamentals" have generally meant metrics such as debt-to-resource ratios, external financing requirements, and banking system capitalization/health. Exhibit 1, below, reviews some of these comparisons, and we believe the stronger position of emerging markets relative to developed markets on these measures is clear.

Look at the difference in fundamentals between emerging markets countries that the market has broadly painted as "vulnerable", such as Brazil.

Exhibit 1 (on the next page) illustrates three additional points.

- "The Babies in the Bathwater" (Brazil, Russia, Nigeria, Indonesia… countries that show up as attractive on our frameworks) have very different fundamentals from the "Bathwater" (Malaysia, India, Turkey… countries that show up as unattractive on our frameworks)…indicating to us that Brazil is getting painted with too broad a brush. Brazil has a much better fiscal stance, far higher reserves, the highest real interest rates, and a current account deficit that is just not that high (3.2%, before the country's weaker currency has had its impact). We could say the same thing about Indonesia getting unfairly painted with India's brush, but we will not delve into that yet, as we think that Indonesia's policy response is more nascent than Brazil's. We will only note that headline inflation (which we use across all countries for internal consistency) in Indonesia is about double the core rate, and, in addition, for other reasons, the recent spike seems to us to be transitory.
- Brazil has among the highest reserve buffers of emerging markets, as measured by reserves-to-imports. In our view, this means it can credibly intervene in currency markets, which it has recently done, and that higher interest rates bite that much harder. The "Bathwater" countries, on the other hand, have consistently low reserve-to-import ratios, and are thus more permanently threatened by a market downturn.
- Japan has a lot of reserves. If intra-Asian currency-swap arrangements (similar to the Federal Reserve's bilateral currency swaps with certain central banks) via the Chiang-Mai initiative or more generally are organized, then they should be taken seriously.

"Good fundamentals" mean more than just mental comfort in the face of asset price weakness.

We note (again) the following specific examples of how "good fundamentals" manifest in the market. However, the general point is that emerging markets' bond markets do not depend solely on their central banks to purchase their bonds…domestic pension funds, global central banks, and other private actors freely choose to buy their bonds.

- In the face of the May/June sell-off in emerging market debt, Nigeria canceled a bill auction because market interest rates were too high. The government does not need the liquidity, and just stopped issuing when yields spiked. Romania and Thailand, similarly, canceled domestic debt auctions, due to their unwillingness to borrow, not the market's unwillingness to lend.
- Other central banks are buying emerging market debt on a secular basis. A decade ago, around three-quarters of China's reserves were U.S. Treasuries. Now they make up less than one half of its reserves.
- We met with domestic pension funds in Mexico and Thailand, for example, and the refrain is the same – they are natural buyers of duration, have allowed cash to build up, and will buy duration once U.S. Treasuries have stabilized.

One of the most important "fundamentals" happens to pay monthly – Brazil has among the world's highest real and nominal interest rates, and emerging market debt generally pays much higher real interest rates than developed market debt.

Exhibit 1: Emerging Markets Appear Better Than Developed Markets

	Overall Fiscal Balance, % GDP (2013F)	Gross General Government Debt, % GDP (2013F)	Reserves/Import Coverage, Months (2Q-2013)	Current Account Balance, % GDP (2013F)	Real Interest Rates (10 Year), %
EM	-2.2	34.3	10	1.02	2.5
DM	-4.7	109.3	2.5***	-0.11	1.06****
Emerging Markets "Babies" - To Keep					
Brazil	-1.2	67.2	17.2	-3.5	4.3
Russia	0.4	17.9	16.7	1.9	1.3
Indonesia	-2.8	23.6	6.0	-2.6	-0.2
Nigeria	-0.3	10.4	8.7**	5.5	4.5
Emerging Markets "Bathwater" - To Throw Out					
Malaysia	-4.0	56.0	7.9	4.4	2.0
India	-8.3	66.4	6.4*	-4.2	2.7
Turkey	-3.3	35.5	5.5	-7.5	1.3
Advanced Economies					
Japan	-9.8	245.4	18.7	1.5	0.0
Eurozone	-2.9	95.0	3.9	1.9	0.6
USA	-6.5	108.1	0.7	-2.9	0.8

Source: IMF Fiscal Monitor, WEO, Bloomberg. Data as of April 2013
* May 2013
** December 2012
*** 2012; Source: Moody's Statistical Handbook (May 2013) and IMF WEO
**** G10

Exhibit 2 shows to us that the market may be risking pricing in far too many interest rates hikes in Brazil – another hallmark of a possible market over-reaction. Even if the Brazilian central bank continues to hike interest rates by another 100 basis points through January 2014, the market appears to be pricing in far more hikes, despite Brazil already having such high real interest rates, and with headline inflation trending down.

And this aggressive stance towards inflation is shared generally by emerging markets, which generally pay higher real interest rates than developed markets.

In previous monthlies, we have shown real interest rates in emerging economies to be very high relative to their fundamentals, compared to developed market bonds with very low real yields relative to their fundamentals (which includes variables such as debts and deficits, external financing needs, reserves, etc.). What stands out to us is the much higher real rates in certain emerging markets relative to their fundamentals, and the consistently low real rates relative to fundamentals in developed markets.

Our bottom line is that we believe Brazil's ongoing interest rate hikes and moves to stabilize its currency should work. And we are struck by how much of the policy "work" has already happened via higher interest rates and a weaker currency.

In the old days, a country had to perform a maxi-devaluation after draining away reserves defending some currency peg that was established because of high inflation expectations. Those inflation expectations are just not there anymore, and countries appear to have learned (even Indonesia, recently), to let the market set a price for their currencies and intervene properly only at that point. In the old days, there was always a deep fiscal problem (whether on balance sheet, or via the banking system) that required high political costs to address. It is hard for us to see that here. Put differently, Brazil may see an improving current account balance just with the passage of time, and high real interest rates should provide a significant cushion as that becomes more obvious.

There are plenty of risks - Brazil is hardly problem-free, selling of emerging market debt can overwhelm buying in the short-term, and many emerging markets remain vulnerable (Malaysia, India, and Turkey come to mind)…however, we believe that is a reason not to own them, rather than to shun emerging market debt altogether.

We've spoken at length about Brazil in the past, so we'll just highlight our view that state bank-directed lending, a poor economic structure, and a government that seems to have lost much of the footing of the preceding Lula government remain appear to big problems. We see ratings downgrade risk in the coming 12 months, too. Still, we see any political price paid by the current government as especially market positive, as the policy response would be even more aggressively orthodox under any new government (even if, because of the government's declining popularity, former President Lula decides to replace current President Rousseff as their party's candidate).

Many emerging markets are vulnerable, in our opinion, with India and Malaysia worth noting – India because its problems are so intractable, and Malaysia because its problems are not reflected in asset prices (as were India's many months ago).

We remain very averse to Indian domestic debt, for multiple reasons, but mainly because we think the Indian government has gotten itself into a box, and only a bigger crisis will precipitate the politics necessary to address it. While we discussed our aversion in articles after a visit with the central bank and other authorities in India about six months ago, our bottom line remains the same.

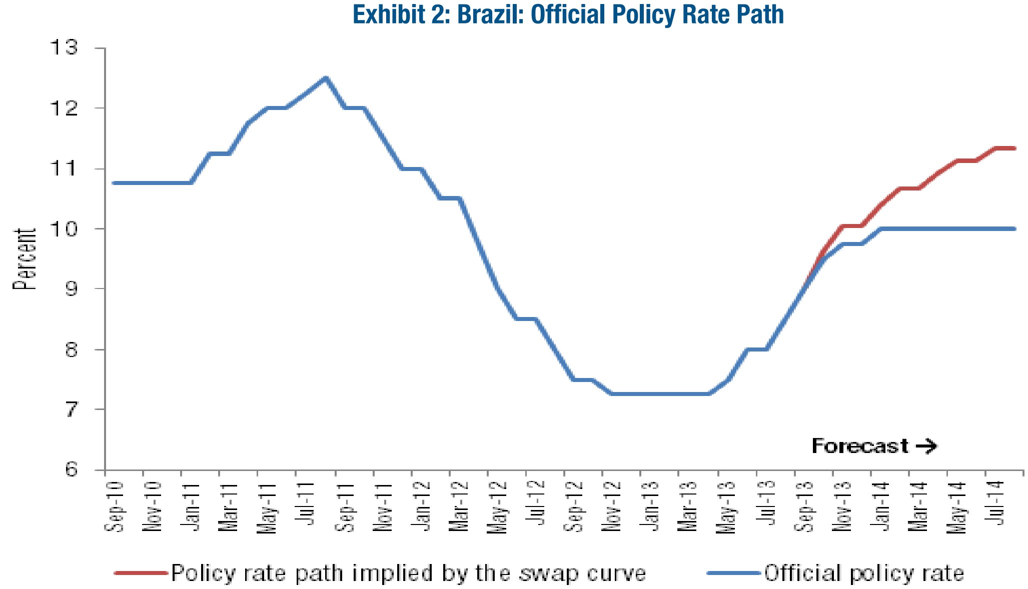
The country's reserves are too low, its banks opaque even for, well… banks, inflation expectations strike us as un-anchored, and government policy keeps confusing causes with results (such as imposing capital controls in response to gold purchases, rather than boosting confidence with structural reforms). All that we would like to note with Malaysia is that the country has one of the most foreign-owned domestic bond markets in the world, and we see looming off-balance-sheet debt problems, and ratings downgrades…in a market that has been seen (rightly, for a time) as one of the safer havens in Asia.

Finally, if sellers of emerging market debt are more motivated than buyers, we believe emerging market debt will likely go down – we remain respectful of the exit of capital from emerging market debt. We are only arguing that we are in a phase of this process where a number of countries – Brazil is one of them – now offer potentially good value as we transition to this higher-yielding world.

The biggest risk to emerging market debt, in our view, is simply that sellers get more motivated than buyers. We see this risk mitigated, importantly, by the market weakness itself – higher interest rates and a weaker currency are already "working", and balance sheets are strong.

Still, we believe that idiosyncratic emerging market bonds can transition a portfolio as we move to whatever new interest rate environment may exist, and that in the long run emerging markets' higher real interest rates and stronger fundamentals could potentially generate higher returns relative to developed market bonds.

Exhibit 2: Brazil: Official Policy Rate Path



Source: Bloomberg, Van Eck Research. Data as of August 31, 2013

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.

Exposure Types and Significant Changes

During the transition to higher yields this summer, we stated that we would use cash (in a range of 0%-10%) as a shock-absorber. We are no longer intending to do that – we believe that the market has adjusted sufficiently, and as such, a fully-invested strategy is, in our view, sensible.

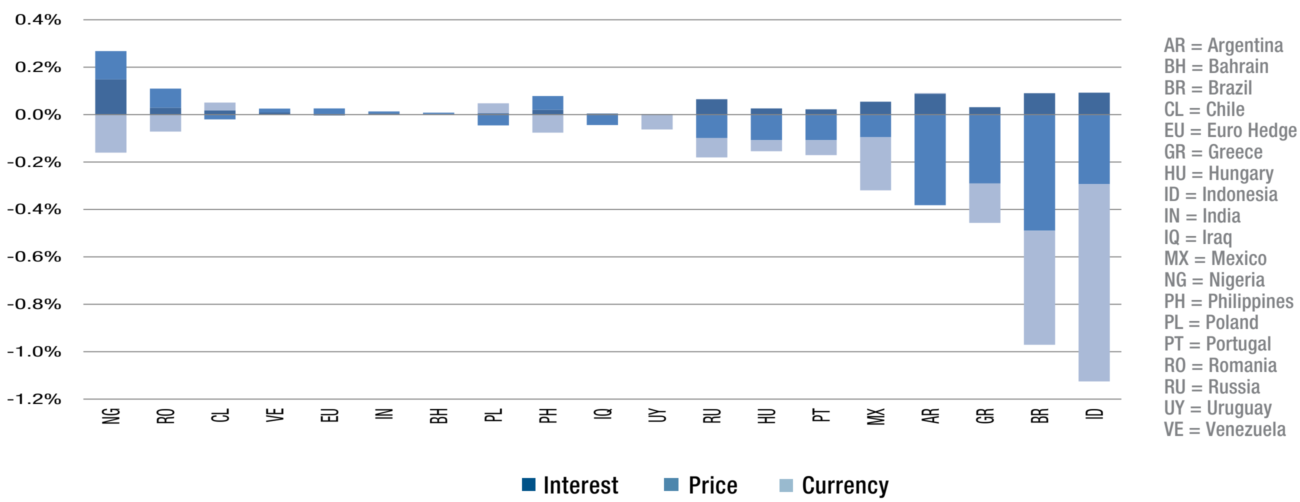
Biggest Country- and Bond-Level Changes

Some of our top five country exposures changed during the month. We closed our exposure to the Philippines completely, and reduced Romania significantly. We also added Argentina in hard-currency as a top position, and Indonesia became a top position due to a growing allocation, as well as to the exit of Philippines and Romania from our top five. Nigeria, Brazil, and Russia remain in our top five.

Fund Performance

For August, the Fund returned -3.12%, compared to -4.09% in the local-currency index (GBI-EM Index), and -2.56% in the hard-currency index (EMBI Index). The Fund's biggest winners in August were Nigeria (local), Romania (local), and Chile (local). The Fund's biggest losers were Indonesia (local), Brazil (local), and Greece (hard). The market's best performers of the past month were Egypt, Belize, and Serbia in hard currency, and Chile, Nigeria, and China in local currency. The markets' worst performers of the past month were Indonesia, Uruguay, and Iraq in hard-currency, and Indonesia, India, and Turkey in local-currency.

Price, Interest and Currency ("FX") Components of Fund Returns by Country



Average Annual Total Returns (%) as of August 31, 2013

	1 Mo*	YTD	Life
Class A: NAV (Inception 7/9/12)	-3.12	-9.59	0.36
Class A: Maximum 5.75% load	-8.73	-14.77	-4.68
GBI-EM Index	-4.09	-11.45	--
EMBI Index	-2.56	-9.04	--

Average Annual Total Returns (%) as of June 30, 2013

	1 Mo*	YTD	Life
Class A: NAV (Inception 7/9/12)	-8.77	-8.50	1.62
Class A: Maximum 5.75% load	-14.00	-13.74	-4.20
GBI-EM Index	-4.13	-7.15	--
EMBI Index	-4.91	-7.77	--

Expenses: Class A: Gross 1.67%; Net 1.25%. Expenses are capped contractually until 05/01/14 at 1.25% for Class A. Caps exclude certain expenses, such as interest. The tables 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.

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 Source: Van Eck Research, Factset. All weightings as of August 31, 2013.

Emerging Markets Hard Currency Bonds refers to bonds denominated in currencies that are generally widely accepted around the world (such as the US 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. The Barclays U.S. Aggregate Bond Index is a market capitalization-weighted index representing most U.S. traded investment grade bonds. The index comprises government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturity of the bonds in the index are over one year.

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.

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. An investor 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.

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