

## Manager Commentary

### Hard-Currency Emerging Markets Debt Outperforms Local in July

By: Eric Fine, Portfolio Manager

#### Overview

We continue to believe that the emerging markets (EM) debt sell-off in May and June was technically driven. Our favored diagnosis is narrative – a lot of money flowed into EM debt over the last several years, with flows accelerating over the last six months, and the asset class was hit by a duration sell-off and U.S. dollar rally. An additional argument might be that the most foreign-owned local markets sold-off the most. Moreover, “taper” talk triggered the sell-off, while we’ve argued that the only sentence about the taper that should be uttered is “the Federal Reserve (“Fed”) will taper if it can, and won’t if it cannot.” Now, it might be useful to discuss the Fed’s particular reaction function (for example, unemployment at some target rate), and we certainly are not saying U.S. yields cannot go higher, we are just emphasizing that the taper is bound – the Fed won’t bankrupt the U.S. government nor weaken the U.S. housing market.

The May/June sell-off was characterized by high correlations between EM debt and U.S. Treasuries, which is a big deviation from the long-term relationship...which is a negative correlation. From the peak to the trough (May 2 to July 5), EM debt had a roughly 0.4 correlation with U.S. Treasuries (0.4 for the hard-currency EMBI index, 0.38 for the local-currency GBI-EM index). Normally, though, the relationship is negative. Post U.S. crisis, the correlation is -0.26 for local-currency and -0.05 for hard-currency. Our process is not mean-reversion based, but to us this deviation from trend seems to be consistent with a stance that sees these selloffs as a buying opportunity (though we are not saying that the bottom has been hit... just that we believe the stance should be opportunistic).

Put differently, if one is worried about duration, EM debt is not the obvious candidate to worry about most in our opinion, relative to other fixed income – we see no case for developed market (DM) government bonds, for instance. The Barclays Aggregate Bond Index, for example, had a 0.97 correlation with U.S. Treasuries during the May/June sell-off...but also a 0.97 correlation during the multi-year post-U.S.-crisis period. As we discussed in earlier monthlies, rising U.S. yields are consistent with rising final demand, which generally improves EM fundamentals. We are not saying that EM debt won’t get hit, but we are saying that we believe it is supportive of fundamentals as DM demands EM exports. More importantly, consider the warning sign sent by the big sell-off (around 12%) in Japanese government bonds (JGB) between April and May, where it may take a decade of coupons (plus or minus, depending on tenor) to make your money back.

Has the bottom been hit? Our answer is that, in our view, there is probably going to be another test of the EM debt market when or if the U.S. 10-year tests 3%. We do not really have any fundamental argument for that view, though. The rule-of-thumb that U.S. growth and the U.S. 10-year yield should be equal is in fact counter to another sell-off in U.S. bonds. It is difficult for us to see sustainable U.S. growth of 3% given the “morphine” policy choices already made (i.e., guarantee everything and be on painkillers/low growth for a few decades rather than doing the hard work of physical therapy). Our view, to be self-critical, is mostly intuitive. It simply seems to us that 3% is there to be tested, so the market will test it. This, and the impact on outflows from EM debt remains the biggest risk, in our opinion.

What are we doing about this? We are doing two things – using cash as we transition to a potentially higher-yield environment, and emphasizing idiosyncrasy...investments where the primary reference point is not the U.S. 10-year. We discussed our use of cash in previous monthlies. Basically, we want to take cash higher (around 10%) when we are concerned about another technical sell-off, but take cash back down when the technicals are priced in. This will hopefully allow us to both seek to preserve capital to fight another day, and also try to take advantage of tradable rallies. Once whatever new range in Treasuries is established, this stance will likely end.

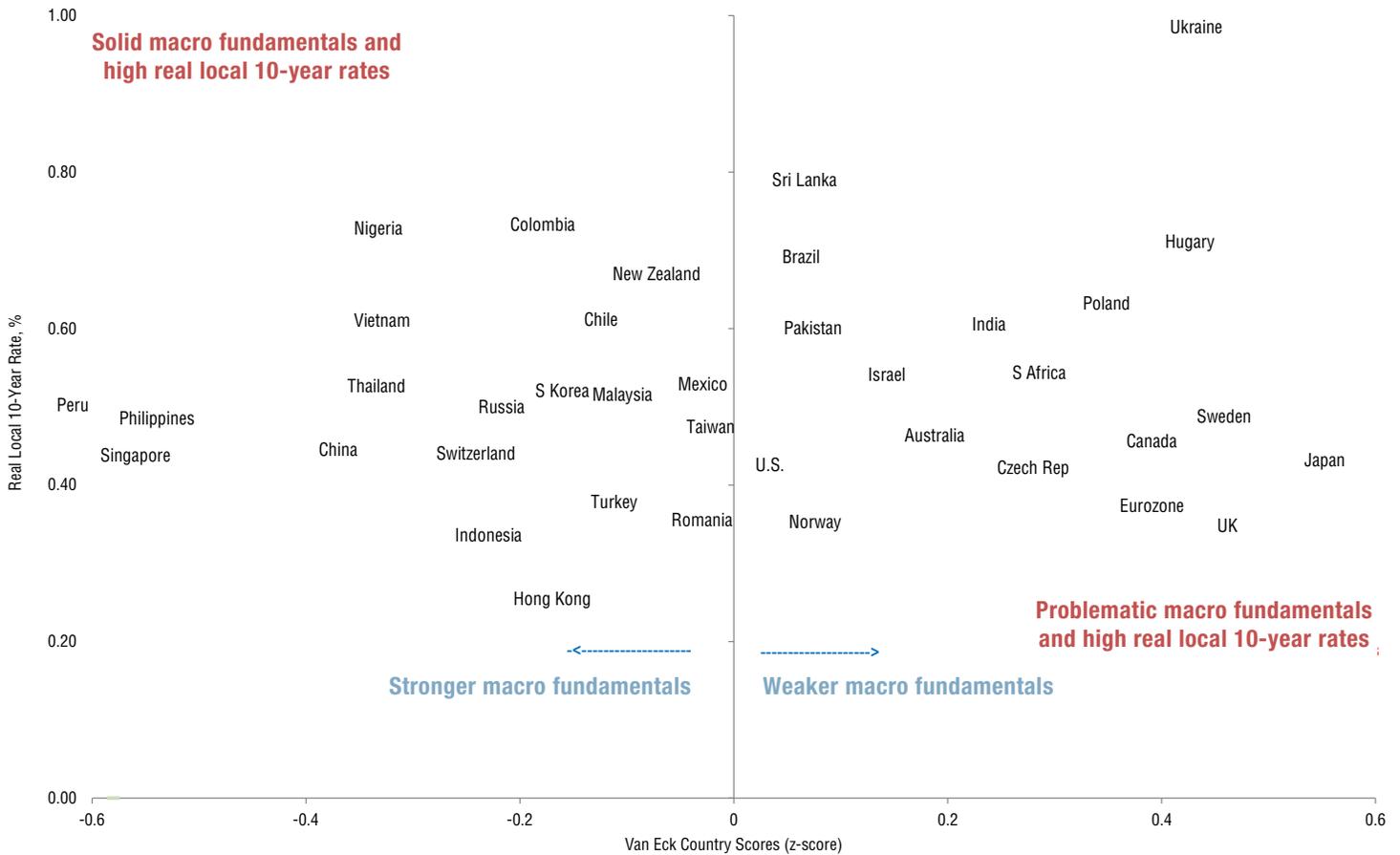
We find idiosyncrasy in some local- and hard-currency bond markets, with low foreign ownership a component. The best examples of these local-currency investments include Brazil and Nigeria. Both countries have high real and nominal rates relative to their fundamentals, both countries appear to be credibly intervening to stabilize their currency and bond markets from a position of balance sheet strength, and Brazil strikes us as much less favored...its bond market is only 10% foreign-owned. The best examples of hard-currency investments we are looking at for idiosyncrasy include Argentina, Portugal, and Greece. In Argentina, local-law, dollar-denominated debt issued by state government have high yields (17%), are not popular with foreign investors, and there could be a positive political and policy path in Argentina. In Portugal and Greece, they are cheap on our models, and since most of their non-traded debt is owed to the official sector, we believe that the market (and the International Monetary Fund) will soon make new assumptions on its roll-ability. In particular, we think one of such assumptions may be that this official debt will roll infinitely and at a relatively low cost. This may improve debt-sustainability results dramatically. In any case, our point on these types of trades is that we do not wake up and look at U.S. Treasuries as the primary determinant of their direction...they are idiosyncratic, in our opinion.

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.

Exhibit 1 below compares our country fundamental ranking with real yields. The most attractive quadrant is strong fundamentals with high real yields. We have two points to make here. First, most of our local-currency exposure is comprised of countries with solid fundamentals and high real yields, Nigeria, for example. But, in our opinion, the portion of the chart you may want to add exposure to are those countries that appear to have poor fundamentals and low real yields, such as UK Gilts.

Within whatever bond allocation an investor is examining, we do not see the case for DM bonds. We believe that DM bonds have limited risk / reward potential. The market has no excuse anymore, moreover, with JGBs having been the worst performing bond market. Think how many years of coupons one will need to make up for the 10%+ losses in JGBs.

Exhibit 1 – Interest Rate and Macro Economy Strength Scatterplot



Source: Van Eck Research, Bloomberg. Analysis as of July 2013.

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Mutual Funds



**Exposure Types and Significant Changes**

■ We reduced cash to around 4%, from 11%. We are raising and lowering cash in this range as we transition to what could potentially be a higher yield environment.

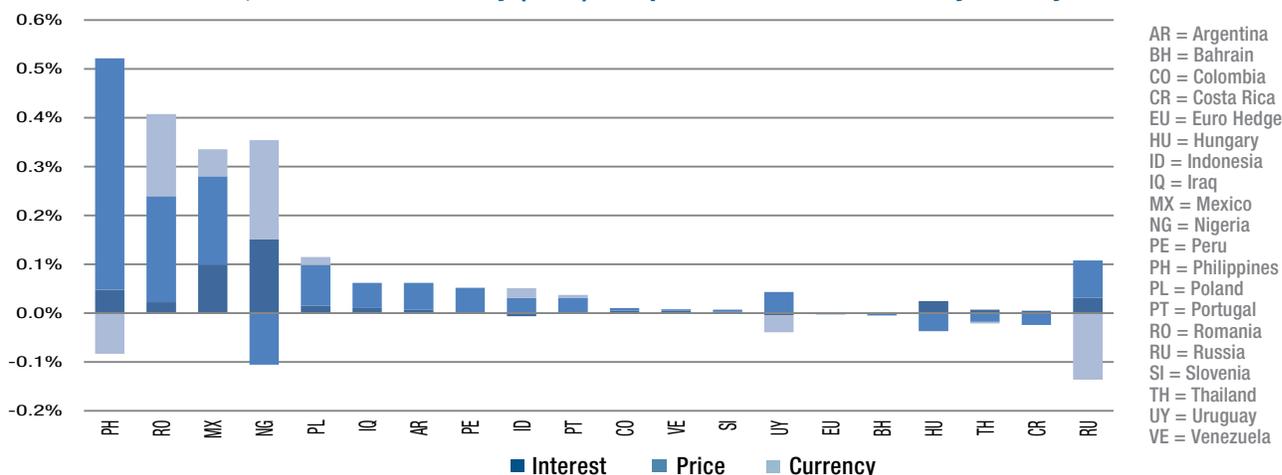
**Biggest Country- and Bond-Level Changes**

- Our top five country exposures did not change significantly. Nigeria, Brazil, Mexico, and Philippines remained in the top four, with Indonesia now in the top five, replacing Uruguay.
- We closed all currency hedges that were hedging our Mexican peso, Brazilian real, and Chilean peso currency risk.

**Fund Performance**

For July, the Fund returned 1.99%, compared to -0.56% in the local-currency index (GBI-EM Index), and 1.21% in the hard-currency index (EMBI Index). The Fund's biggest winners in July were Philippines (local), Romania (local), Mexico (hard and local), and Nigeria (local). The Fund's biggest losers were Russia (local), Costa Rica (hard), and Thailand (local). The market's best performers of the past month were Ivory Coast, Egypt, and Iraq in hard currency, and Poland, Philippines, and Colombia in local currency. The markets' worst performers of the past month were Mongolia, Turkey, and Indonesia in hard-currency, and India, Indonesia, and Malaysia in local-currency.

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



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

	1 Mo*	YTD	Life
Class A: NAV (Inception 7/9/12)	1.99	-6.67	3.44
Class A: Maximum 5.75% load	-3.89	-12.02	-2.16
GBI-EM Index	-0.56	-7.67	--
EMBI Index	1.21	-6.65	--

**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.

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Data Source: Van Eck Research, Factset. All weightings as of July 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.

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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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