EM Debt: Adjusting the Sails

By Eric Fine, Portfolio Manager

VanEck Emerging Markets Bond Fund

EMBAX / EMBUX / EMBYX

Market Review

The Fund was down 1.94% in September, 1 basis point worse than its benchmark which was down 1.93%. YTD as of end-September, the Fund is up 2.94%, while its benchmark is down 3.41%. In September, the biggest detractors were Sri Lanka, Mexico and Indonesia, while the biggest contributors were Uruguay, Suriname and Mongolia. We continued to make risk-reducing changes in September. The main thematic drivers of those country-specific adjustments were lower margins for error in a number of bond markets, many EM debt markets at pre-COVID-19 highs, country-specific setbacks and risks of second COVID-19 waves/U.S. election uncertainty.

We have closed a number of positions that worked well, for a combination of valuation and fundamental reasons. We have entirely closed our Argentina sovereign exposure, as telegraphed in our monthlies. Our view on Argentina was simply that bond prices didn't reflect the likely deal that would be reached with creditors, not that it was attractive beyond that. Argentina contributed positively to the Fund YTD. We closed our Indonesia local currency position because we believe the government is engaging in risky monetary experimentation, it's a popular overweight and markets have barely reacted to these new risks. We also closed our exposures to Angola, Gabon and Sri Lanka. Here, we essentially continued to take profits as price targets were hit and fundamental developments worsened. All of these contributed positively to the Fund YTD.

We also increased exposures to China in local currency, adding to our Chinese corporate bonds in USD. In local currency, China pays higher real rates following its selloff of recent months, its external accounts have improved sharply, steady index inclusion is creating supportive technicals and policy credibility is slowly making Chinese local bonds a safer haven. We also increased our exposure to Thailand local currency.

We end September with a carry of 6.6%, duration of 5.7 and approximately 25% in local currency. Our largest exposures are now China (USD corporates and local currency sovereign), Mexico (local currency and USD), and Uruguay (local currency). No other positions were higher than 5% of the Fund, so diversification increased further in September.

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions in September were: China, Mexico, Uruguay, South Africa and Thailand.

- We increased our local currency exposures in China and Thailand. China's real rates are grinding higher, as authorities are not flooding the system with cheap credit, sticking to the "drip" stimulus instead. In addition to reducing a risk of asset bubbles, this also reduces inflation pressures going forward. So, as a result, China's local valuations now look much more attractive than several months ago. In addition, FTSE Russell has confirmed that China's government bonds will be included in its benchmark World Government Bond Index (WGBI) starting from October 2021. It is estimated that the inclusion might attract as much as USD120B inflows. This should create a nice technical backdrop for the currency, all things being equal. Another aspect of the inclusion is China's emerging as a "safer haven" investment destination, given that the WGBI focuses on high-quality and highly liquid bonds. These factors strengthened China's policy, economic and technical test scores. As regards Thailand, the country had experienced another political noise spike, but political risks seem to be exaggerated. Local bond valuations are solid and the latest data releases confirmed that the current account is recovering from the COVID-19-related slump. The Thai baht also has one of the highest historic correlations with the Chinese yuan, which improves the technical test score for the country.

- We also increased our hard currency sovereign and corporate exposures in Mongolia and the United Arab Emirates (UAE). Mongolia's new issue was attractively priced. An additional consideration is that Mongolia is uniquely positioned to benefit from China's ongoing recovery. Both factors improved the technical test score for the country. As regards the UAE, a deal with Israel that ends its boycott is a game changer—for the country and for the entire region. This positive shift in relations with Israel gave a huge boost to the country's policy test score. As regards our corporate exposure in the UAE, this UAE-based hydrocarbons storage company came with a small, high-yielding, discount-priced bond (hence the improved technical test score). The company benefits from an excellent location in one of the largest storage hubs, state-of-the-art facilities and a revenue stream of which 50% is represented by take or pay contracts. Management has been prudent and waited until it was fully contracted before expanding operations. In addition, the need for storage is not dependent on oil prices and therefore less volatile.
- Finally, we increased our hard currency sovereign exposure in Costa Rica. This decision reflects a more significant progress (and building consensus) on a new IMF program and the fact that the 2021 budget proposals incorporate agencies. This improved the country's policy test score. The country's valuations also improved, moving the highest initial allocation to Bucket #1, which strengthened Costa Rica's technical test score.
- We reduced our hard currency sovereign exposures in Angola, Sri Lanka and Gabon. The market did not like a passage from the IMF's staff report on Angola, which suggested that more debt relief would be required if the price of oil goes further down. This is hardly a revelation, but it worsened the technical test score for the country. Sri Lanka's IMF issues are much more serious. Contrary to expectations, the new government showed significantly less willingness to engage the IMF immediately after the elections. However, it is still not clear how authorities will be able to manage without the deal. Numerous calls with officials failed to clarify the situation and we lowered the country's policy and economic test scores as a result. As a confirmation of our decision, Sri Lanka got a rating downgrade soon after we divested. Our main concern in Gabon was that domestic policies might be at risk as the positive impact of the G20 debt deal fades. In addition, the country's VaR is quite high, which we thought warranted reducing exposure during the period of global de-risking. In terms of our investment process, this worsened the country's technical test score.
- We also decided to fully exit from our hard currency corporate exposure and local exposure in Indonesia. On the sovereign level, there was some unsettling news on the central bank's independence—specifically, that representatives of Ministry of Finance and other ministers can sit on the board and vote for policy decisions. The reintroduction of large-scale COVID-19 restrictions in Jakarta introduced new downside risks to growth and fiscal performance. Summing up, the country's economic, policy and technical test scores worsened at the same time. Regarding our corporate exposure in Indonesia, the basic motivation was de-risking and taking profit after having made a decent amount of money.
- Finally, we reduced our hard currency sovereign and corporate exposures in Argentina. We started this process of sovereign divesting after the successful debt exchange and we continued to lock in profits in September. On a corporate level, we also participated in the recent bond exchange, receiving both an upfront payment, plus any and all interest payments that were due. As a general decision to lower our exposure to Argentina, we have begun to take profits in this area as well.

Fund Performance

The VanEck Emerging Markets Bond Fund (Class A shares excluding sales charge) lost 1.94% in September compared to a loss of 1.93 % for the 50/50 J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM) local currency and the J.P. Morgan Emerging Markets Bond Index (EMBI) hard-currency index.

Turning to the market's performance, GBI-EM's biggest winners were Uruguay, South Africa, and Philippines. Its biggest losers were Brazil, Russia and Poland. The EMBI's biggest winners were Ecuador, Romania, and Philippines. Its losers were Sri Lanka, Argentina and Mexico.

Average Annual Total Returns (%) as of September 30, 2020

	1 Mo†	3 Mo†	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	-1.94	5.42	2.94	7.48	5.36	2.21
Class A: Maximum 5.75% Load	-7.57	-0.64	-2.98	1.30	4.12	1.47
50 GBI-EM GD / 50% EMBI GD	-1.93	1.47	-3.41	-0.02	5.53	2.57

Average Annual Total Returns (%) as of June 30, 2020

	1 Mo†	3 Mo†	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	6.93	22.09	-2.35	0.25	1.94	1.60
Class A: Maximum 5.75% Load	0.79	15.07	-7.97	-5.51	0.74	0.85
50 GBI-EM GD / 50% EMBI GD	1.99	11.05	-4.80	-1.10	3.89	2.46

† Monthly returns are not annualized.

Expenses: Class A: Gross 2.69%; Net 1.26%. Expenses are capped contractually until 05/01/21 at 1.25% for Class A. Caps exclude acquired fund fees and expenses, interest expense, trading expenses, dividends and interest payments on securities sold short, taxes and extraordinary expenses. 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 temporary contractual 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). An index's performance is not illustrative of the Fund's performance. Certain indices may take into account withholding taxes. 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 call 800.826.2333 or visit vaneck.com for performance current to the most recent month ended.

Prior to May 1, 2020, the fund was known as the VanEck Unconstrained Emerging Markets Bond Fund.

Value at risk (VaR) is a statistic that measures and quantifies the level of financial risk within a firm, portfolio or position over a specific time frame. Beta is a measure of the volatility–or systematic risk–of a security or portfolio compared to the market as a whole. Correlation a statistic that measures the degree to which two securities move in relation to each other.

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. Carry is the benefit or cost for owning an asset.

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. Certain indices may take into account withholding taxes. An index's performance is not illustrative of the Fund's performance. Indices are not securities in which investments can be made. The Fund's benchmark index (50% GBI-EM/50% EMBI) is a blended index consisting of 50% J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified and 50% J.P. Morgan Emerging Markets Bond Index (EMBI). The J.P. Morgan GBI-EM Global Diversified tracks local currency bonds issued by Emerging Markets governments. The J.P. Morgan 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.

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 below investment grade securities, credit, currency management strategies, debt securities, derivatives, emerging market securities, foreign currency transactions, foreign securities, hedging, other investment companies, Latin American issuers, management, market, non-diversification, operational, portfolio turnover, sectors and sovereign bond risks. 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, and the risk that a position could not be closed when most advantageous. The Fund may also be subject to risks associated with non-investment grade securities.

Investors should consider the Fund's investment objective, risks, charges, and expenses of the investment company carefully before investing. Bond and bond funds will decrease in value as interest rates rise. The prospectus and summary prospectus contain this and 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.

VanEck®

Van Eck Securities Corporation, Distributor
666 Third Avenue | New York, NY 10017
vaneck.com | 800.826.2333