VanEck FUNDS

Big Wheel Keeps on Turning: Even Lower Rates

By Eric Fine, Portfolio Manager

VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

Market Review

We see three key global macroeconomic developments which continue to point toward lower U.S. interest rates, but not to stronger EMFX: the Fed, ongoing trade tension with China and Brexit (yes, Brexit). Starting with the Fed, we have the same view we have articulated in previous monthlies. The U.S. is a relatively closed economy. Challenges to global growth are coming mostly from the more open economies in Asia and the Eurozone. A Fed cutting rates to accommodate risks that are unlikely to have an impact on the U.S. economy is going to end up one of two ways in our view (a repeat of our longstanding view). Either the July 25 bps cut buys some time and the U.S. economy continues to diverge positively from rest of world (ROW), but especially Eurozone, in which case, relative growth and interest rates should support the USD. Or, the initial market expectation of almost 100 bps of cuts (as priced prior to the actual cut, but before the presser) is right, which seems to us as only likely if the U.S. is entering a recession, which would also be very USD-bullish in our opinion. We suppose that there's a third scenario of the ROW bottoming and beginning to outperform growth expectations, but we don't see a strong case or evidence there, with a Germany reluctant to stimulate, a China (rightly, in our view) tilting its focus to stability and a U.S. moving into election mode. Trade tensions are still winding their way through the global economy. Japan, for example, just took Korea off its White List of preferred trading partners. If that scenario ensues, then we would be more constructive on generic EMFX. We're not seeing it.

Trade tension with China is another key risk factor, with the market having so far taken the simple fact of ongoing negotiation as a reason to see the cliff edge as still down the road, and with most analysts (superficially, in our opinion) saying: "Trump will make a deal because he needs SPX up." Dancing near cliff edges is not our desired position. We'd also note the perhaps obvious (but curiously un-noted, in our readings) game-theoretic implications of the standoff between China and Hong Kong. This standoff in the context of critical trade negotiations creates powerful incentives for actors in Hong Kong (organized or not) to take advantage of China's perceived vulnerability. The fact that the White House chose to warn of People' Liberation Army (PLA) troop concentrations near Hong Kong (PLA has troops inside Hong Kong as a matter of course) and Chinese warnings to stop "Western" provocations in Hong Kong politics, highlight the risks of tit-for-tat escalation (one of the classic game theory scenarios). By the way, the result of the U.S.' latest sanctions announcement (the 10% on $300B announced on August 1) was to push U.S. interest rates down, which certainly makes it easier for the U.S. to continue trade sanctions.

Another risk, in our view, comes from Brexit (yes, you might be bored to tears about Brexit, but Brexit is not bored with you yet). There are serious risks to European growth from a hard exit, in our view. Most reactions to Brexit discussions are either: "Gee, we're still talking about this confusing thing?" Or: "The impact on the British economy will be x, y and z". We don't see how the implications for the U.K. economy are supposed to matter to us in emerging markets (EM), or to anyone, really, as the economy is just not large enough and its currency is a significant buffer. What is important, in our view, and which goes very un-noted (perhaps because Brexit is unpopular with most elite media) is the impact of Brexit on the German economy. Roughly 20% of German automobile exports are to the U.K., and autos are notoriously central to the German economy. Weak growth at least fits into the global divergence theme we said we were concerned about at the beginning (that U.S. growth chugs along, and ROW does not, leading to divergence and USD strength). Weaker confidence would fit a weaker growth scenario. A recession that provides a risky context for persistent political uncertainty would be an even worse scenario.

The big winners for the Fund in July were Ukraine and Argentina. We've discussed both in the past, and see both names as idiosyncratic and excellent fits with the broader risk environment. Ukraine has already seen its sea-change election of both executive and legislature and it is the most reformist government this writer has seen in decades of following the country. Land reform, if pursued as is being hinted at, would be an incredible boost to the growth outlook (one of our securities is a gross domestic product (GDP) warrant that has value at certain GDP growth levels). In Argentina, we have a more nimble, tactical attitude, but current reformist President Mauricio Macri is rising in the polls going into October elections, as the economy and inflation stabilize. One could also argue that the Fund benefited from its low allocation to local currency, but since both local currency was slightly down in July and hard currency was barely up, we think that's not an obvious interpretation.

There are problems in "emerging markets," but these are largely for local currency and some specific countries that are de-rating, but that happen to be large index components. Our reaction, as always, is to avoid them, not to become bearish on "emerging markets." First, let's get local currency out of the way. Low-yielding local (such as in Poland, Hungary, Czech and Thailand) is clearly vulnerable to any hiccups in the reversal of the Fed's rate-cutting cycle (Chair Powell said it was just a mid-cycle adjustment in a hiking cycle). That's over one-quarter of the local currency index right there. Then we have Mexico and South Africa, which we see as de-rating situations (see our earlier monthlies and country write-ups), and Russia, where we've never seen a better economic setup or value, but which has so far failed tests in our investment process due to sanctions risk and what we see as greater downside, if they escalate, than the upside, if they don't escalate. That's another quarter of the index.

We believe that the portfolio we've built is designed well for the risks we outline above—carry is approximately 7%, duration is around 5, and the Fund has only approximately one-quarter of its exposure to EMFX (and this exposure is largely very idiosyncratic). Some might see our decreased (since May) local currency allocations as bearish on EM debt. We hasten to add that the carry on our fund is higher than almost all of the local currency markets we are avoiding. Our bottom line is that we view our portfolio as a collection of the cheapest EM bonds on a bottom-up basis, that have been culled from those that are vulnerable to either global macro strains discussed above, or country-specific strains based on our investment process' tests. We still have high carry and risk, just not in local currency, and not in index stalwarts like Mexico, South Africa and Russia (and Poland, Czech and Thailand), where we see any potential "EM is in trouble" stories being generated. July saw an early test of the portfolio.

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions are currently: Indonesia, Brazil, Ukraine, Nigeria and Argentina.

- We increased our local currency exposure in Indonesia. The country is consistently in our top valuation bucket and the fact that it was under-owned made it an attractive proposition, especially as the central bank is now in a better position to lower the policy rate further. In terms of our investment process, this improved the technical test score for the country.

- We also increased our local currency exposure in Uruguay and Ukraine. In Ukraine, President Volodymyr Zelensky's party did extremely well in the parliamentary elections, improving the outlook for structural reform and growth. In terms of our investment process, this strengthened the country's policy test score. In Uruguay, the main drivers were the positive primary elections outcome and the fact that inflation is expected to decrease in Q3. In terms of our investment process, this improved the economic and policy test scores for the country.

- Finally, we increased our hard currency sovereign exposures in Jordan and Costa Rica, and hard currency corporate exposure in Vietnam. In Vietnam, we purchased a new issue from an electric utility, an industry with generally stable revenues and profitability, given the nature of its concession contracts. In addition to being highly rated in our model, the issue priced very wide versus the sovereign, in spite of the fact that it sells its electricity (guaranteed) to the sovereign-controlled grid and its energy needs are guaranteed by the sovereign-owned coal mining company. In Jordan and Costa Rica, the main reason is that both credits are less affected by global drivers, while having very attractive valuations. In terms of our investment process, this improved the technical test score for both countries.

- We reduced local currency exposure in Argentina and Mexico, and hard currency corporate exposure in Mexico. Argentina's political test score is coming under greater pressure as we are getting closer to the August primary elections. The polling margins between two main candidates are way too narrow for comfort, despite the fact that President Macri was able to benefit from the nascent economic turnaround. In Mexico, the country's policy test score dropped significantly following the unexpected resignation of its minister of finance and the unveiling of the underwhelming business plan for the state-owned oil giant Pemex. The uncertainty about the central bank's inflation-targeting mandate was another contributing factor. Regarding our corporate exposure, we participated in a new issue Mexican REIT. Although the framework is not optimal for studying REITs because of their specialized nature, our calculations showed this bond as being cheap versus industry comparables.

- We also reduced hard currency sovereign exposure in Tunisia. The main reason was the increased political uncertainty following the death of the country's president. The election outcome in the fall is too early to predict, and it is not yet clear whether/how the new government will engage with the International Monetary Fund (IMF). These developments weakened the policy test score for the country.

- Finally, we reduced hard currency sovereign exposures in Armenia and Azerbaijan. Both countries have a very low spread-to-yield ratio, which makes them susceptible to duration selloffs in the case that the Fed turns out less dovish than the market expects. In terms of our investment process, this weakens the technical test score for both countries.

Fund Performance

The VanEck Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) gained 2.12% in July compared to a gain of 1.07% 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 Turkey, Brazil, and Thailand. The biggest losers were Poland, South Africa, and Colombia. The EMBI's biggest winners were Oman, Argentina, and Brazil. The biggest losers were Venezuela, South Africa, and Lebanon.

Average Annual Total Returns (%) as of July 31, 2019

	1 Mo†	3 Mo†	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	2.12	5.58	12.00	7.98	-0.09	2.08
Class A: Maximum 5.75% Load	-3.75	-0.48	5.48	1.78	-1.26	1.23
50 GBI-EM GD / 50% EMBI GD	1.07	5.95	11.21	9.52	2.74	3.10

Average Annual Total Returns (%) as of March 31, 2019

	1 Mo†	3 Mo†	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	0.47	5.85	5.85	-3.48	-0.11	1.33
Class A: Maximum 5.75% Load	-5.29	-0.31	-0.31	-9.00	-1.28	0.44
50 GBI-EM GD / 50% EMBI GD	0.05	4.93	4.93	-1.78	2.37	2.37

†Monthly returns are not annualized.

Expenses: Class A: Gross 2.05%; Net 1.26%. Expenses are capped contractually until 05/01/20 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.

R-Squared is the percentage of a fund's movements that can be explained by movements in a benchmark index.
DXY is the U.S. Dollar Index that measures the value of the United States Dollar relative to a basket of foreign currencies.

The World Government Bond Index (WGBI) measures the performance of fixed-rate, local currency, investment-grade sovereign bonds. The WGBI is a widely used benchmark that currently comprises sovereign debt from over 20 countries, denominated in a variety of currencies, and has more than 30 years of history available. The WGBI is a broad benchmark providing exposure to the global sovereign fixed income market. The Blended 50/50 Emerging Markets Debt Index is an appropriate benchmark because it represents the various components of the emerging markets fixed income universe.

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.

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 and portfolio managers of other investment strategies may take an opposite opinion than those stated herein. Not intended to be a forecast of future events, a guarantee of future results or investment advice. Current market conditions may not continue. Non-VanEck proprietary information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

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.