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VanEck FUNDS

Under Pressure

By Eric Fine, Portfolio Manager

VanEck - Unconstrained Emerging Markets Bond UCITS

USD R1 Inc: IE00BYXQSJ74

USD I1 Inc: IE00BYXQSF37

USD I2 Inc: IE00BYXQSG44

USD M Inc: IE00BYXQSH50

EUR Hedged I1 Inc: IE00BYXQSD13

EUR Hedged I2 Inc: IE00BYX22V58

Average Annual Total Returns (%) as of 30 November 2018

	1 Mo†	3 Mo†	1 Yr	3 Yr	Life
USD R1 Inc (Inception 12/6/14)	-1.47	-1.21	-6.24	2.09	-3.09
USD I1 Inc (Inception 20/8/13)	-1.39	-0.99	-5.29	2.93	0.63
USD I2 Inc (Inception 20/8/13)	-1.38	-0.97	-5.38	3.11	0.77
USD M Inc (Inception 18/9/14)	-1.42	-1.04	-5.55	2.85	-2.23
EUR Hedged I1 Inc (Inception 6/10/15)	-1.59	-1.59	-7.96	0.94	1.52
EUR Hedged I2 Inc (Inception 22/08/17)	-1.58	-1.62	-8.05	-	-5.88
50% GBI-EM/50% EMBI USD[1]	1.19	1.14	-5.10	4.51	1.97

†*Periods greater than one year are annualized.*

[1]*Life performance for the 50% GBI-EM/50% EMBI - USD benchmark is presented in U.S. Dollars (USD) as of Class I1 inception date of 20/8/2013*

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Fund Review

The VanEck - Unconstrained Emerging Markets Bond UCITS (Class USD I1) lost 1.39% in November, compared to a gain of 1.19% 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.

The Fund's biggest winners were Indonesia, Poland, and Costa Rica. The Fund's least contributors were Brazil, Ukraine, and Venezuela. Turning to the market's performance, the GBI-EM's biggest winners were Indonesia, South Africa, and Turkey. The biggest losers were Argentina, Brazil, and Mexico. The EMBI's biggest winners were Mozambique, Zambia, and Costa Rica. The biggest losers were Venezuela, Nigeria, and Ghana.

Market Review

What a month November was. Two key market drivers of 2018 – the Fed, and "China trade" – whipped all asset classes back and forth. In addition, two key asset prices – U.S. stocks and U.S. Treasuries – dominated sentiment. Emerging markets (EM) debt had been buffeted earlier in 2018 by these two market drivers, when an initial rise in U.S. yields was viewed as positive for EM debt (EMD), with only U.S. dollar bonds selling off in the first quarter of the year, while local currency bonds continued to rally. As 2018 wore on and U.S. growth started clearly diverging from weakening developed markets (DM) growth, all EM bonds (local currency and U.S. dollar-denominated) suffered. November followed what was a similarly volatile October. Since this is the setup going into 2019, this is what we think.

We see three scenarios going forward: goldilocks (bullish for EM risk), U.S./global recession (bearish for EM risk), and continued economic divergence (bearish for EM risk). Let us examine each one, starting with goldilocks. In this scenario, the market is in the midst of a somewhat typical post-QE (quantitative easing) selloff. The cause – Fed tightening – will be reversed as global uncertainty feeds back to policymakers, and they "blink." This was the case (to varying degrees) with: the European debt crisis in 2011, the "taper tantrum" in 2013, and the commodities-related selloff of 2015. In the goldilocks scenario, global growth will re-couple with U.S. growth, as U.S. policymakers ease (relatively) monetary policy and get the U.S dollar (USD) down, boosting EM debt. Under this scenario, we will be back to the "synchronized global growth" theme that existed up until the first quarter of 2018.

The continued economic divergence scenario is bearish for EM debt, in our view. In this scenario, we get more of what we saw in 2018 (excepting the first quarter). That is, a U.S. economy that continues to outperform the rest of the world. We would note that U.S. purchasing managers' indices (PMIs) have been in the high-50s throughout 2018 and that that remains the case in recent months. This is in comparison to European and Asian PMIs that have clearly declined. In our thinking, such a scenario keeps the Fed in tightening mode and wary of inflation pressures. With higher relative growth and interest rates, the USD remains under upward pressure. As a result, we would expect hard currency EM debt to be pressured by rising yields, and local currency EM debt to be pressured by a rising USD.

The volatility and asset price weakness of October and November introduce a third scenario: U.S./global recession, which would be even more bearish for EM debt, in our view. In this scenario, it is just a matter of time for relative global weakness to catch up with a U.S. economy that is in the late stages of its economic cycle. As a result, the U.S. economy will turn, hitting global demand. Policymakers might not have the usual flexibility and tools to react to this scenario. Global leverage has increased following the global financial crisis, so fiscal policy might not be as usable. Similarly, given that the Fed's tightening of policy has been very shallow compared to that of previous recoveries, the usual monetary forbearance might not be that strong. This, and the deeper problem that all of these policies have already been tried, makes any recession a potentially more troublesome one for markets. In any case, (our prior) is that the USD is boosted in the event of a U.S./global recession, as "risk-off" and position closing translates fairly directly into U.S. dollar buying.

These scenarios strike us as generally bearish for EM debt. Even though we see a chance of a goldilocks scenario, it would be short-lived and is substantially already priced in, in our opinion. The reason we believe such a goldilocks scenario would be short-lived is that it depends on Fed forbearance. As we have argued before, what has been unique about the current Fed tightening cycle is that financial conditions largely eased when the Fed intended the opposite, mostly because the U.S. dollar didn't weaken significantly against the major DM currencies (EUR and JPY). So, let us say goldilocks happens. We see a Fed moving quickly to concern that financial conditions are easing excessively. Moreover, such a scenario is arguably already priced into bond markets. As of this writing (December 10, 2018, 11:00am), the market-implied policy rate sees 35 bps of Fed hikes over the next 12 months, with only a 71% chance of a 25 bps hike in December. Put differently, economic conditions would need to worsen substantially for the Fed to truly be on hold. So much so that we might be in the U.S./global recession scenario for such implied policy rates to hold. There is a fine line between the goldilocks scenario and the US/global recession scenario.

Our stance remains largely intact, as a result, although we have brought the portfolio a little closer to benchmark, given market volatility as it entertains these scenarios and as the goldilocks scenario plays out. This has involved some increase in our local currency exposures, as we had limited local currency exposure this year following the first quarter. Our increases here (details below) were to countries that are cheap in our investment process and which, we believe, are responding properly to tougher global conditions (Indonesia, which recently surprised by hiking interest rates, and Peru). We are not, for example, investing in Turkey or Mexico, as, in each, we see big turns to the worse in economic policy (so technically, they get a "fail" on the Policy/Politics test in our investment process). We emphasize this because our calculations indicate that problematic (in our view) markets such as Turkey's local market have generated 3% of the 3.8% return in the GBI-EM from September 1 to the close of December 6, 2018. We do not intend to chase rallies in fundamentally flawed countries simply because they rally. We also increased exposure to some smaller U.S. dollar-denominated sovereigns that had sold off excessively (in our opinion), and in which we had underweights (Guatemala and El Salvador).

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions are currently: Brazil, Argentina, Indonesia, South Korea, and Mongolia.

- We increased local currency exposure in Indonesia and Peru. Indonesia's pre-emptive monetary policy moves created good anchors, while the macro flow remains mostly benign. In terms of our investment process, this improved the economic and policy scores for the country. In Peru, the post-August price correction created a better entry point against the backdrop of contained political risks, strong external buffers, robust growth, and low inflation. In terms of our investment process, this translates into the improved technical score for the country.

- We also increased our hard currency sovereign exposures in Guatemala and El Salvador. The bond of our choice in Guatemala continues to look attractive valuation wise, while the country's low debt makes it an attractive investment option if global rates' volatility increases further. In addition, the congressional approval of the 2019 budget improved the policy score for the country. In El Salvador, an agreement on the fiscal bill opened the door for talks on the 2019 budget and the rollover authorization for the 2019 sovereign bond, improving the policy and fundamental scores for the country.

- We increased our hard currency sovereign exposure in Costa Rica, following the approval of fiscal reform by the country's congress. In terms of our investment process, this improved the policy score for the country.

- We reduced local currency exposures in Poland and Brazil. In Poland, concerns about the bank scandal implications for the central bank (which can potentially affect the monetary policy stance) were the main reason for the reduction, as they worsened the country's policy score. In Brazil, the market participants are waiting for more visibility on the reform front (social security reform, in particular), which is unlikely to materialize until early 2019, capping the near-term improvement in the policy score.

- We reduced hard currency sovereign exposure in Dominican Republic. Even though macroeconomic fundamentals are solid, we decided to bring out exposure closer to neutral in order to focus on other opportunities. In terms of our investment process, this lowered the technical score for the country.

- We also reduced hard currency corporate exposures in South Africa and Colombia. In Colombia, changes to the corporate bond's covenants made it a weaker credit. In South Africa, the corporate's outlook got affected by uncertainty about the sovereign, worsening the technical score for the credit.

International Monetary Fund (IMF) is an international U.S.-based organization of 189 countries focused on international trade, financial stability, and economic growth.

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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.

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