VanEck FUNDS

Investable Rally

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 31 January 2019

	1 Mo†	3 Mo†	1 Yr	3 Yr	Life
USD R1 Inc (Inception 12/6/14)	5.00	3.82	-4.27	4.76	-1.88
USD I1 Inc (Inception 20/8/13)	5.08	4.06	-3.35	5.63	1.60
USD I2 Inc (Inception 20/8/13)	5.07	4.07	-3.40	5.81	1.75
USD M Inc (Inception 18/9/14)	5.06	4.00	-3.56	5.55	-0.94
EUR Hedged I1 Inc (Inception 6/10/15)	4.84	3.25	-6.13	3.43	2.92
EUR Hedged I2 Inc (Inception 22/08/17)	4.76	3.17	-6.24	-	-2.06
50% GBI-EM/50% EMBI USD[1]	4.93	7.60	-2.63	7.29	3.06

†*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) gained 5.08% in January, compared to a gain of 4.93% 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.

The Fund's biggest winners were Venezuela, Brazil, and Argentina. The Fund's least contributors were Mongolia, Suriname, and Georgia. Turning to the market's performance, the GBI-EM's biggest winners were Argentina, Turkey, and South Africa. The biggest losers were Romania,and Dominican Republic. The EMBI's biggest winners were Venezuela, Argentina, and Zambia. The biggest losers were Mozambique, Suriname, and Bahrain.

Market Review

We see an ongoing case for an investable rally in EM debt, and the Fund continued to increase the allocations to local currency debt that began in November. More specifically, we see three key global macroeconomic tailwinds for EM debt – U.S. monetary policy, China stimulus, and relative EM growth. The Fed seems to have "blinked", China is stimulating fiscal policy while maintaining tight control over the currency, and EM growth looks to have bottomed. Moreover, developments in Brazil (progress on pension reform) and Argentina (monetary and fiscal tightening are seem so successful the currency has traded through its intervention band) add to a good EM story. Risks are there, of course, and a big one is that the countries we are concerned about – Mexico, Turkey, and South Africa – are large index components and make up the bulk of the high-yielders. Our response is, of course, to avoid them, but many market participants are not flexible enough to avoid bad credits if they are large index components.

Starting with the global macroeconomic situation, we see three key global tailwinds for EM debt: U.S. monetary policy, China stimulus, and relative EM growth. First, on U.S. monetary policy, as we argued last month, the Fed looks like it has "blinked" in the face of perceived risks, particularly those that crystallized in weaker U.S. stock market prices. When we saw Fed communications, what struck us was the following: Chinese economic weakness was cited as a reason for caution (un-prompted, that is, not in response to a question). EM economic weakness was cited as a reason for caution (again, un-prompted). In addition, the balance sheet itself was volunteered to be adjustable, and not on an "auto-pilot" to shrinking. This view of a blinking Fed was reinforced in January, with more explicit invocation of flexibility on the Fed's balance sheet, in countering real or perceived economic and/or asset-price weakness. Of particular note, in our opinion, is the significant drop in 2-year interest rates from just under 3% in mid-November 2018, to around 2.5% end-December, with the rate hovering around 2.5% at the end of January after attempting a selloff. As we argued in our last monthly, this should represent downside risk to the USD, and is thus a tailwind to EM local currencies (EMFX).

China stimulus is noteworthy, partially because it seems ongoing. Fiscal policy is the primary engine engaged, with announced tax reductions already equal to 1.5% of gross domestic product (GDP). Monetary policy forbearance, although targeted, has also been engaged, with reserve requirement ratio cuts and other downward pressure on interest rates in train.

EM growth is also finally showing signs of hope. Forecast revisions of EM growth are up, compared to forecast revisions of developed markets (DM) growth. This is a major development in our view. One need only point to 2018 to see the impact relative growth had on EM debt, particularly local currency debt. As we noted in our December monthly, a good first quarter for EM debt in 2018 was driven by synchronized global growth. When EM growth lagged DM growth in the second and third quarters, though, EM debt sold off fairly significantly, and countries with large external financing requirements went into crisis (Turkey and Argentina being the biggest examples).

Moving to EM-specific developments, there are some positive ones, particularly in Brazil and Argentina. In Brazil, the new government appears focused on fixing the country's key vulnerability – fiscal policy, particularly pensions. A plan is expected to be announced in the first weeks of February, and there is a good chance that it can be approved quickly. (Please see our recent report, Brazil: Belle of the Ball, for more details). In Argentina, policy success is already stark if the Argentine peso is any measure. It has strengthened beyond the intervention band envisioned by the current International Monetary Fund (IMF) program, and the central bank has been intervening buying U.S. dollars at initial clips of $50 million per day of intervention, but recently increasing to clips of $75 million per day of intervention. If Argentina's nascent stabilization continues, it could bode well for October presidential elections, which could possibly cement the move to orthodox economic policies begun under President Macri.

There are clearly risks to EM debt. One of the biggest, in our view, is that countries where we see serious vulnerabilities – Mexico, South Africa, and Turkey - happen to be large index components. In Mexico, we are concerned about the deviation between newly-elected President López Obrador's promises of spending to domestic audiences, and his promises of fiscal rectitude to the financial community. This may take time to play out, but at some point the divergence will hit asset prices. Ratings agency Fitch gave a foretaste of this by downgrading state-owned oil company Pemex two notches to BBB-. We would add that too many in the market expect sovereign support for Pemex to play out as it did in Brazil with Petrobras (namely, that the sovereign support stabilized Petrobras). We do not see that as the important comparison. In Brazil, the sovereign has a very strong external position, with very high reserves ($372 billion in Brazil versus $186 billion in Mexico, excluding gold) and an extremely orthodox government (during its crisis and after). We are also concerned about heterodox policy in Turkey, as we argued in our previous monthly. Its currency rally, in our opinion, is largely just the result of light positioning combined with significant USD borrowing that injected U.S. dollars into the financial system. Finally, in South Africa, we see policy drifting, with no strong reformist direction. Perhaps President Ramaphosa will be more decisive after his likely re-election, but we do not see evidence for this yet.

As a result of the above, we have increased local currency exposure and duration, while still avoiding overweight exposure to Mexico, South Africa, and Turkey. We are also avoiding Russia, due to the asymmetric downside risk to bond prices in the event that U.S. sanctions escalate (i.e., we are not predicting more sanctions, we simply think that in the non-trivial probability of their happening, the downside to bond prices is significant). Together, this means we are avoiding all of the big-index-weight, local currency high-yielders other than Brazil. Nonetheless, despite avoiding these high-flyers, we were clearly exposed to market beta in the strong month of January (the Fund was up 5.08% (I1 share), compared to 4.93% for the 50/50 benchmark and 5.46% for JPM GBI EM GD (local currency) and 4.41% for JPM EMBI GD (hard currency). As a result, we remain comfortable avoiding these high-yielding, but problematic, countries.

Exposure Types and Significant Changes

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

- We increased our local currency exposure in Poland and the Czech Republic. Both countries are attracting attention as a macro-solid Euro play. The Czech central bank is at the end of its tightening cycle, while its Polish counterpart is not even thinking about rate hikes. The currencies in both economies enjoy support from the EU funds and comfortable current account positions. The recent political murmurs in Poland created a nice entry point in a situation when valuations continue to look attractive relative to fundamentals, in or opinion. In terms of our investment process, this translates into strong technical and economic test scores for both countries.

- We also increased our local currency exposure in Indonesia and Malaysia. Indonesia was pressured too much by the market relative to its fundamentals, improving the technical score and creating an attractive entry opportunity. In Malaysia, we feel comfortable being market-weight now given supportive global tailwinds, which improved the technical test score for the country.

- We also increased hard currency sovereign and local exposure in Colombia. The Colombian peso was lagging behind the recent oil price rally, raising the technical score for the country. Meanwhile, inflation remains under control and the overall macroeconomic background looks supportive, in our view. Regarding the hard currency bond, this was a new issue that we believe looked cheap relative to the fundamentals.

- We reduced local currency exposure in Mexico and South Africa. Mexico's policy and economic scores deteriorated a lot in the past few weeks, following the submission of a questionable budget draft for 2019, another bout of inflation pressures, and weakening growth. The state-owned company Pemex was downgraded by two notches, raising concerns that the sovereign credit might be the next in line. South Africa's valuations were getting tighter, pushing down the technical test score for the country. We used proceeds to fund more attractive opportunities.

- We reduced hard currency sovereign exposure in Georgia and Mongolia, and hard currency quasi-sovereign exposure in Mongolia. Valuations in both countries no longer looked attractive and we used the proceeds to fund more interesting opportunities. In terms of our investment process, the technical scores for both countries went down (a lot).

- We also reduced hard currency quasi-sovereign and local currency exposure in Argentina. On the local side, our main concern is the central bank's interventions to limit the peso's appreciation (which are now growing in size). In our view, this significantly limits upside for this kind of exposure, worsening the policy score for the country. As regards the provincial hard currency debt, we believe the valuation was getting stretched, worsening the technical test score.

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.

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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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