

EM Debt: USD's Death Greatly Exaggerated

By Eric Fine, Portfolio Manager

VanEck - Unconstrained Emerging Markets Bond UCITS

USD R1 Inc: IE00BYXQJ74

USD I2 Inc: IE00BYXQSG44

EUR Hedged I1 Inc: IE00BYXQSD13

USD I1 Inc: IE00BYXQSF37

USD M Inc*: IE00BYXQSH50

EUR Hedged I2 Inc: IE00BYX22V58

Average Annual Total Returns (%) as of 31 July 2020

	1 Mo [†]	3 Mo [†]	1 Yr	3 Yr	Life
USD R1 Inc (Inception 12/6/14)	4.51	22.90	0.07	1.92	-0.49
USD I1 Inc (Inception 20/8/13)	4.60	23.20	1.04	2.76	2.32
USD I2 Inc (Inception 20/8/13)	4.61	23.24	1.12	2.94	2.45
USD M Inc* (Inception 18/9/14)	4.58	23.14	0.83	2.68	0.48
EUR Hedged I1 Inc (Inception 6/10/15)	4.45	22.78	-1.95	0.01	2.58
EUR Hedged I2 Inc (Inception 22/08/17)	4.45	22.80	-1.96	-	-0.07
50% GBI-EM/50% EMBI USD ¹	3.37	11.35	1.15	3.07	3.42

^{*} Investment through authorized financial institutions only.

[†] 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 4.60% in July compared to a gain of 3.37 % 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 Brazil, Mexico, and Poland. Its biggest losers were Russia, Turkey and Thailand. The EMBI's biggest winners were Mexico, Saudi Arabia, and Qatar. Its losers were Turkey, Ukraine and Lebanon.

Market Review

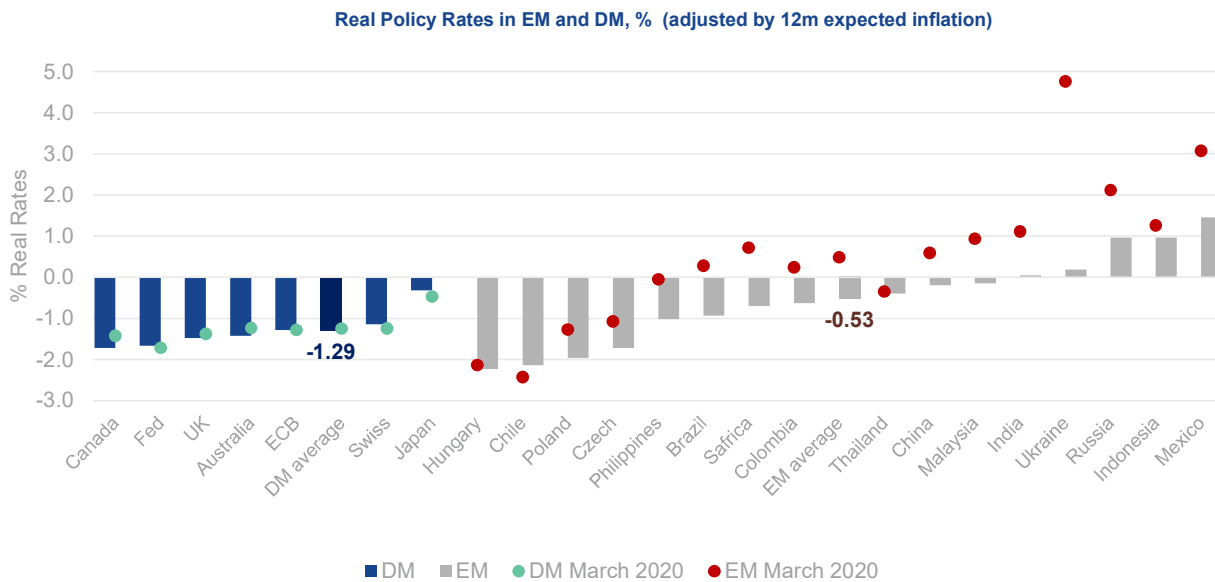
Reports of the USD's death are greatly exaggerated, in our opinion, and even if there is a case, EM debt is not the obvious beneficiary. In fact, we find the argument almost too vague to address. The argument is essentially that low interest rates, quantitative easings (QEs), credit easings (purchases of corporate bonds), the prospect of MMT (modern monetary theory), political and social unrest and even "empire decline" are going to lead to a sharp drop in the U.S. dollar. Our basic problem with this theory as a basis for investing is as follows. First, what is going to go up against the U.S. dollar? One needs to be specific and name the specific U.S. dollar cross one is predicting will collapse (which we review below). Second, in the decade-plus since the Fed's first QE, this dollar collapse has absolutely not happened. EM local currency debt hasn't even returned its carry in the post-QE era (it's returned a tiny fraction of it, in fact). Keep in mind that these money experiments are not unique to the U.S. and even EM economies (some with justification, some with little) are engaging in them.

U.S. dollar decline may be a fun and eventually correct story for the coming decade or so, but is not a practical guide to investing, in our strong view, due to USD debt issuance. One further point on the debt issuance dynamic of past decades. Here's the simplified form: on a risk-off moment, U.S. rates decline and the dollar rallies, the last significantly due to the scramble for USD to repay USD debt. The planet eventually borrows more USD at "low" rates, but eventually the next risk-off happens triggering another scramble for dollars to repay debt, rates decline further, the planet eventually borrows even more USD, and the cycle continues. We believe the most underappreciated upside force on the USD is the relentless short as represented by, so far, endless USD borrowing.

Let's get more specific, given that the "end of the dollar" is a thing again, and ask whether now is really the time to get excited about EM local currencies—the problem is that basically all EM currencies have low real interest rates which have already rallied. Look at the Exhibit below. Only Russia, Mexico and Indonesia show positive real interest rates. We're fine with Indonesia, as its cheapness in our investment process is reinforced by passing the second step of "tests" therein and it remains a significant portion of our limited EM local currency exposure. Russia faces sanctions risks and Mexico just can't seem to grow, though. Please refer to our other reports for more details on those situations and, whether we end up right or wrong on those particular countries, our point is that we're not in a target-rich environment for local currency value. Importantly, a major new dynamic in almost all EM economies is now fairly established—currency weakness doesn't pass through into inflation, so it is an incredibly attractive path of least resistance for policy makers. Who wants their currency strong if there's no inflation? Particularly in a global economy with ongoing headwinds. Please, tell us, which country wants a stronger currency as a matter of policy? Policy rates state the opposite loud and clear.

Now, speaking of what, specifically, can go up against the USD, EUR is an interesting candidate, with implications for EM countries in the EU. First, though, one must recognize that EUR's recent and much-anticipated "rally" of recent weeks has a simpler answer than "dollar decline" theory. It is that the global growth baton's been handed to Europe for a while due to their most recent stimulus program. That could arguably boost relative growth rates, or at least make it a plausible story for a few months. But, please, give us a break—the Eurozone is not an optimal currency zone (which requires common fiscal, banking and financing, as well as labor mobility and popular support) and everyone knows it. It may become one, it looks a little like it's trying to become one at each crisis, but it is not an "apples to apples" comparison to the U.S. at the moment. Still, getting even more specific, the EU has a number of members who will receive large amounts (as a percentage of their respective GDPs) of lending and grant support. Now we're talking specific catalysts, specific inflows and specific growth drivers. In our opinion, and in our actions, this has translated into bullishness on Romania, a key recipient of EU assistance, as well as the only EU emerging market country that is cheap on the core of our investment process. Again, no grand theory is driving us into Romanian local currency debt—each country's currency and local rates must stand or fall on their own merits.

Exhibit 1 – Real Policy Rates in EM and DM



Source: Bloomberg. Data as of 6/30/2020.

Turkey is a poster child for the bad ending you get without good monetary, fiscal and balance of payments policies, all while you're borrowing USD and assuming these loans will roll. In our view, the country is simply running out of USD (whether in government reserves or domestic banking system assets), using them to defend the currency. Gross reserves remain superficially threatening at \$80B, but the government has been forcing state and other banks to sell their dollars. There's risk that foreign banks curtail this lending, which would be one obvious and common crisis trigger. Similarly, at some point, Turks will realize that the USD "in" their bank accounts is not there, due to bad government policy and then the real fireworks will start (we have not seen real fireworks there, but when locals run on the currency, that will be a new state of nature). What's so depressing is that this seems to be the most common way countries learn—our entire careers have been spent witnessing versions of this exact dynamic and thankfully many EM voters are wary of heterodox economic policy as a result of these economic disasters. Anyway, our point is that having USD or access to them is pretty important in a world awash in USD liabilities/debt. "USD decline" theory is not a substitute for a rigorous, country-by-country process in our view.

There is still plenty of good news in EM. We believe there are opportunities abound if you're not confined to owning only local, or corporate, or sovereign debt. Broadly speaking, the fact that currency weakness stabilizes EM economies is terrific, in our view, just not if you own them when they're performing their adjustment function. EM fundamentals are characterized by low debts relative to developed markets (DM). Global stimulus is likely to find its way into EM bonds, just as it did post-GFC. But, it all points to having a bottom-up, country-by-country attitude to EM debt investing, rather than an "EM debt good, EM debt bad" approach. EM local currency has its place and we think will have its days, but "dollar decline" theory is not a substitute for a country-by-country investment process in our view. Notice that our core point – that there aren't even a lot of high policy interest rates in the EM debt world – could be viewed as very bullish for gold prices. Van Eck's Joe Foster, Portfolio Manager of the VanEck International Investors Gold Fund, has a gold price target of \$3,400. Our only reinforcing point would be that if we're correct that there's not tons of value in EM local currency, the gold price will rise in multiple currencies, which would underline a bullish gold market.

We end July with carry of 7.5%, duration of 5.3 and approximately 30% in local currency. Our largest exposures remain Indonesia (local), Argentina (USD), Angola (USD), Ukraine (USD and local), El Salvador (USD), Mexico (local) and Uruguay (local). All we can say is that we wake up in the morning thinking about our country exposures, not about global macro issues. Performance so far has been consistent with our stance. Our tag-line: (still) oversold and re-rating is (still) a powerful combination.

Our big changes in July were to reduce fund VaR. In particular, we are about to reduce Angola and have reduced our longer-duration Jamaica (both in USD), which were our two highest VaR positions. These investments worked very well, very quickly and we remain overweight, but these positions are also now, by definition, more correlated with global risk given their much higher prices. We are also in the process of reducing positions in Ukraine, El Salvador and Belarus, due to riskier fundamental outlooks there. In Ukraine local currency, the bonds rallied so much they were no longer cheap on our process. Also, policy, especially monetary policy, is looking suspect. This has been a terrific long-term holding and performer for us, but it hit its targets, policy looks riskier and so we are out. In El Salvador, a basically reformist government looks like it doesn't want to get serious about policy and work toward an IMF deal until after elections next year; borrowing from the market at 9.5% for 30 years instead of doing the hard work doesn't inspire confidence. We just had the wrong policy outlook there. In Belarus, we see a country that has so far dealt with its external financing needs with a combination of reform and skillful playing of NATO against Russia. That may be over for a while as the long-standing president faces unprecedented mass protests. We've been in Belarus for a long time, it's been a great performer, we expect it to eventually "work out", but the spreads do not warrant these potential new risks, namely a president focused entirely on power, not a much-needed economic policy agenda. We'll sit that one out until it is resolved or the market overreacts.

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions are currently: Argentina, Indonesia, Mexico, Angola and Uruguay.

- We increased our hard currency sovereign exposures in Sri Lanka and Romania and also our local exposure in Romania. Romania's sovereign bond was a new issue with

good valuations, which we found attractive given our low exposure to the region. In terms of our investment process, this improved the country's technical test score. Valuations of Romania's local bonds also look cheaper and we think that the approval of the EU's COVID emergency package can improve the country's growth outlook and boost inflows to the region. The recent political chatter indicates that the forthcoming pension increase will be relatively limited, which should limit the fiscal impact. In terms of our investment process, this improved the country's policy and economic test scores. As regards Sri Lanka, the country should not have any issues meeting its 2020 debt obligations and it will have a better chance of getting it right with the IMF after the August elections. In terms of our investment process, this improved the country's policy and economic test scores.

- We also increased our hard currency sovereign exposure in Suriname and Tajikistan. We initially put a very small position in Suriname. The country's bonds usually have very good valuations in our framework (the highest valuation bucket) and, in this particular case, we expected a peaceful power transition to more market-friendly government. An additional consideration is that the government should have time to develop the new oil field before the bond's maturity. So, in terms of our investment process, the country's technical and policy/politics scores looked good. The election results confirmed our initial expectations and the incoming government coalition signed an agreement to address several key issues, including the exchange rate adjustment, the official debt level, the central bank's independence and the state-owned companies' efficiency. These developments further improved the country's policy test score. As regards our position in Tajikistan, it's the continuation of the same story—the highest initial valuation bucket, the IMF's assurance that the country's debt is sustainable under current policy commitments and the fact that the government applied to participate in the G20 debt relief program (which can now be expanded). In terms of our investment process, these factors support Tajikistan's technical and policy test scores. These conclusions should not be affected by the pace of Rogun Dam's construction—a major development project in Tajikistan.

- Finally, we increased our hard currency corporate exposure in Georgia. This was a rare cheap new issue in a country that is re-rating, has a low USD debt and an orthodox policy framework. On a specific credit basis, this is a "Bucket 1" company in an industry generally known for its stable cash flows (utilities), in a country where the regulatory framework is favorable, including a USD-indexed revenue stream. In addition, we expect credit improvement on the back of a lower capital expenditures plan which will translate into free cash flow generation. In terms of our investment process, this improved the company's technical and country test scores.
- We reduced our hard currency sovereign exposure in El Salvador. We had several concerns, including a suddenly busy supply pipeline that "replaced" negotiations with the IMF. We understand that the global environment opened a window of opportunity, but the decision to issue a 30-year bond strongly suggests that the liquidity situation might be worse than previously thought and that the government needs U.S. dollars more urgently to support the dollarized economy. These developments worsened the country's technical and policy test scores, and—as a confirmation—the new issue traded badly, dragging the existing yield curve with it.
- We also reduced our local currency and hard currency sovereign exposures in Ukraine and Belarus. Ukraine's catalyst was the resignation of the central bank's governor and the fact that he quoted political pressure as the main reason. The governor's replacement is yet to prove his policy credentials, so we decided that it was too much risk in a situation when sovereign bonds were getting too expensive. Regarding local debt, the new governor seems to favor the weaker exchange rate, while the new official estimates now suggest that inflation will be increasing much faster than previously expected. In terms of our investment process, this lowered the country's policy and technical scores. The main risk we saw in Belarus was the August presidential elections, which proved to be more troubled than the widely expected "status quo". The official numbers point to the incumbent's resounding victory (80% or so), but the opposition is not accepting the results. There are widespread riots (with dozens of wounded and detained), the internet is down,

and the military is deployed in the capital city of Minsk. Both sides question each other's legitimacy, which limits the room for compromise. This heightens concerns that this can generate another proxy conflict in Europe. The local currency is likely to be the adjustment mechanism under this scenario, which is not particularly liquid and therefore can be hit hard. Belarus sovereign bonds might also not be immune to selloff—irrespective of the election's outcome. The Belarussian is very dependent on Russia. In terms of our investment process, this worsened the country's policy/politics test score and therefore we closed out of Belarus.

- Finally, we reduced our hard currency quasi-sovereign exposure in Indonesia and hard currency corporate exposure in Brazil. In Indonesia, our purchase of state-owned enterprise Pertamina was due to the bond's elevated spread to sovereign and expectation that it would tighten versus the sovereign. It became expendable after outperforming the sovereign during our holding period. In addition, the bond had by far the lowest

spread/yield ratio in the portfolio and was not the best on the U.S. dollar price/duration metric either. In terms of our investment process, this worsened the company's technical test score. The main reason for liquidating our corporate position in Brazil was concerns about the sovereign and the "association" impact it might have on other asset classes. The government's handling of the COVID-19 crisis is considered among the worst among major emerging markets and there are multiple concerns about growth and the government's reform agenda, with frequent spikes in political noise. In terms of our investment process, this worsened the company's country 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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