VanEck

VanEck FUNDS

Emerging Markets Offer Attractive Real Rates

By Eric Fine, Portfolio Manager

VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

Market Review

Our basic constructive stance remains, although a potential China growth slowdown, a risk of rising U.S. Treasury yields, and delays in Brazil's pension reform approval are new factors tempering this stance. What are the elements behind our constructive stance? We'll start with the global situation. First, the global economy appears to be in a synchronized global growth phase. Just last month, the International Monetary Fund (IMF) upgraded its global growth forecast for the first time in 20 quarters. Second, moves toward tighter monetary policy (via rates and balance sheet adjustments) are more often than not bullish for risk assets (i.e., credit spreads usually decline), as tighter policy is usually a response to rising demand. Third, risks from Europe have abated for the time being, following French elections, and the "atmospherics" of Franco-German cooperation combined with ongoing upside growth surprises, should be a positive factor. Fourth, the "protectionism" narrative from the new U.S. administration is at least partially digested, and there's a chance that it is in a more constructive phase in which the facts will boil down to spats followed by climb downs.

Before moving fully to the general emerging markets context, we would argue that higher yielding securities should outperform lower yielding in both of the key risk scenarios most investors are concerned about: U.S. Federal Reserve (and European Central Bank) hawkishness or dovishness. Our bottom line is that higher yielding securities should outperform in either a rising yield environment (the carry should compensate for duration and there is risk of spread compression as rising yields reflect rising demand) or in a stable/declining yield environment (that is basically what has been happening under quantitative easing (QE) regimes).

In the general emerging markets context, we would point to the following. First, emerging markets trade and growth look to be stable to improving. Second, external balance sheets remain strong, with the only real decline in reserves coming from China over the past years. Third, inflation looks very subdued, and a number of key emerging markets central banks are maintaining high real interest rates. Russia, Mexico, South Africa, Colombia, Uruguay, and, of course, Brazil, all maintain high policy rates and are seeing a stable or improving inflation trend.

We do have some new concerns. First, there are new question marks about China's growth dynamics. The economy went from Q1 real GDP growth surprising on the upside to surprise on the downside in Q2, in several activity indicators and surveys. The investment community is rife with charts showing China's correlation with commodity prices and a number of factors important to emerging markets economies; we are watching this space more carefully than before.

Second, Brazil's efforts at passing its important social security reform is facing some uncertainty in the context of a market that we think is pricing in a very high probability of passage. We believe some context/review is in order. Brazil pays very high real interest rates (over double expected inflation!). The external accounts have improved massively thanks to collapsed import demand, strong foreign direct investment, and improving exports. The country's key problem is its deteriorating debt dynamic, which is why the government has been so focused on fiscal policy (having passed a spending cap as its first important victory in this effort). Most if not all of the political experts in Brazil say that passage is very likely, but the arguments are not straightforward. We don't see an easy reason as to why a politician would vote

for tough reductions in expected pensions under a political system still reeling from trust/corruption issues. Our bottom line is that the reform will probably be passed but that is a consensus expectation. If it is seriously delayed or worse, the asset price implications are very asymmetric. As a result, stay tuned as our many quarters of comfort with Brazil generally, and recent quarter-plus of comfort with the local market, is waning.

Those are the bigger points. Let's move on to some specific changes we have made to the portfolio and why. First, we reduced Brazil for the reasons stated: we downgraded our policy/politics test score for Brazil, which resulted in a smaller allocation. Second, we reduced Mongolia: these bonds have rallied so much that they no longer offer a high premium relative to their fundamentals (steps one and two of our process need to show a premium for fundamentals). Third, we reduced Mexico: the State of Mexico elections are coming up in June and they could presage the uncertainty of next year's presidential elections. Plus the usual brinksmanship one can expect during NAFTA renegotiations led us to assign a negative policy/politics test score. We remain overweight the local market only less so than before. Fourth, we reduced our exposure to El Salvador: this was entirely due to an inter-party fight over the budget that has since caused the country's rating to be downgraded. Thankfully this was after we came to the conclusion that this was a risk and we closed the position before the hit.

Here are our increased or new positions. First, we increased Uruguay local currency exposure. We had said previously we wanted to increase exposure there slowly – we are doing so. There are no new reasons other than high real interest rates, very strong external accounts, a government that is as serious about inflation as any we have seen in the past decade, and the eventuality of index inclusion for its local bonds. We increased Ecuador exposure in U.S. dollars. The new government is essentially implementing an IMF program without the IMF (due to the political baggage the IMF brings to a "leftist" government). Formally for our process, we upgraded its policy/politics test. Finally, we invested in Ukrainian U.S. dollar bonds. The country has just reached an agreement with the IMF and, for the time being, military tension with Russia seems frozen.

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions are currently: Brazil, Mexico, Russia, Argentina, and South Africa.

Our largest positions are currently: Russia, Argentina, Brazil, South Africa, and Mexico. The changes to our top positions are summarized below.

- We increased hard currency sovereign exposure in Ukraine, Ecuador, and Angola. In Ukraine, the government looks ready to tackle additional structural issues as part of its engagement with the IMF and this should ensure the disbursement of further tranches in the coming months. In Ecuador, the new government is effectively implementing elements of a traditional IMF program (although there is no formal deal yet). In terms of our investment process, this resulted in higher policy/politics scores for these countries.

- We also increased local currency exposure in South Africa and Uruguay. South Africa's macro story appears to be turning around while many political risks are already priced in – we believe this results in the improved vulnerability score for the country. In Uruguay, the government is focusing on fiscal consolidation and the development of the local debt market, whereas the central bank looks fully committed to bringing inflation down on a more sustainable basis. In terms of our investment process, this results in a higher policy score for the country.

- We reduced local currency exposure in Mexico and Brazil. In Mexico, the renewed geopolitical concerns (NAFTA) – that were hitherto almost fully priced out – seem to be returning at the same time as the State of Mexico is preparing for local elections. Both factors lower the policy score for the country. In Brazil, the outlook for the social security reform approval looks murkier – the government was forced to water down the reform bill but it remains to be seen whether this will allow it to secure the required number of votes in the parliament. There is additional uncertainty about the approval's timeline, with more delays down the road. In terms of our investment process, this lowers the country's policy score.

- We also reduced hard currency sovereign exposure in Zambia and El Salvador. In Zambia, we have concerns about the government's ability to implement reforms required by an IMF program. In El Salvador, the wrangling in the parliament resulted in default on the pension debt and a subsequent rating downgrade. In terms of our investment process, we had to lower both countries' policy/politics scores.

- We also reduced hard currency sovereign exposure in Mongolia on valuation concerns and ensuing higher correlation risks. We used these bonds as funding for our duration/local debt exposure.

Fund Performance

The VanEck Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) gained 0.54% in April, compared to 1.33% 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 Argentina, Uruguay and Russia. The Fund's losers included Mexico, Brazil and South Africa. Turning to the market's performance, the GBI-EM's biggest winners were Venezuela, Mozambique and Argentina. The biggest losers were Bolivia, El Salvador and Trinidad and Tobago. The EMBI's biggest winners were Argentina, Colombia and Turkey. The biggest losers were Mexico, Thailand and Romania.

Average Annual Total Returns (%) as of April 30, 2017

	1 Mo†	3 Mo†	YTD	1 Yr	3 Yr	Life
Class A: NAV (Inception 7/9/12)	0.54	4.28	5.97	6.54	-2.43	0.95
Class A: Maximum 5.75% Load	-5.25	-1.74	-0.08	0.45	-4.32	-0.28
50 GBI-EM GD / 50% EMBI GD	1.33	4.65	6.58	6.37	1.85	–

Average Annual Total Returns (%) as of March 31, 2017

	1 Mo†	3 Mo†	YTD	1 Yr	3 Yr	Life
Class A: NAV (Inception 7/9/12)	0.58	5.40	5.40	7.33	-1.79	0.85
Class A: Maximum 5.75% Load	-5.21	-0.61	-0.61	1.14	-3.70	-0.40
50 GBI-EM GD / 50% EMBI GD	1.35	5.18	5.18	7.26	1.76	–

†Monthly returns are not annualized.

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.

Diversification does not assure a profit or prevent against a loss.

Expenses: Class A: Gross 1.68%; Net 1.25%. Expenses are capped contractually until 05/01/18 at 1.25% for Class A. Caps exclude certain expenses, such as interest. 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. 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.

International Monetary Fund (IMF) is an international U.S.-based organization of 188 countries focused on international trade, financial stability, and economic growth.

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. 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 Diversify 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 emerging markets securities. 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, market, credit, management and the risk that a position could not be closed when most advantageous. The Fund may also be subject to credit risk, interest rate risk, sovereign debt risk, tax risk, non-diversification risk and risks associated with non-investment grade securities. Please see the prospectus and summary prospectus for information on these and other risk considerations.

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.