Contagion is a risk
By Eric Fine, Portfolio Manager

VanEck Unconstrained Emerging Markets Bond Fund
EMBAX / EMBCX / EMBUX / EMBYX

Market Review
Our defensive stance remains (virtually no emerging markets local currencies (EMFX), low duration, and “high-ish” carry), and avoidance of some vulnerable names that happen to be big index components such as Turkey, Mexico, Brazil, and Russia. Our rationale remains the same —those countries that are facing idiosyncratic risks are large, emerging markets (EM) growth has not yet turned around, and contagion is a risk until the U.S. Federal Reserve (Fed) reverses course, which seems distant for now, in our opinion.

First, countries we currently believe will face idiosyncratic adversity happen to be big index components, so it could impact index-level performance and, therefore, flows to generic emerging markets debt funds and indices. Turkey is not responding to the challenges of a tougher financing environment at all, and is at risk of capital controls that mean no return of your money, not just losses. Brazil sovereign bonds (local and hard currency) are at risk in an EM contagion due to the country’s deteriorating debt dynamic and large fiscal deficit. It cannot even respond to the market because it is in the midst of presidential elections. Mexico has seen all the good news it can muster so far—NAFTA looks done... Now we are left with the new president AMLO (Andrés Manuel López Obrador), who will likely raise taxes to fund his spending program. Russia’s economy is awesome, but sanctions’ risks from the U.S. create massive downside risks that do not compare to the upside risks if sanctions’ risks fade.

Second, the growth dynamic in EM has not yet improved, and any turnaround does not seem imminent. This is important because the weak EM growth dynamic relative to developed markets (DM) was key in hitting EMFX in 2Q. (Whereas, in 1Q, it was only hard -currency debt that weakened due to yields rising in the U.S.) We see this 2Q dynamic continuing, if not worsening. EMFX weakness is getting central banks to become more hawkish, creating more growth headwinds. In addition, generalized EM asset price weakness and risks to portfolio flows add additional potential headwinds.

Third, the market dynamic is looking increasingly like a contagion. We are not saying that it is going to be like 1994 or 1997/1998, but so far, it feels as if it is proceeding that way, and if it is a contagion, then only the Fed reversing course can stop it. Such a dovish turn seems unlikely with U.S. equities near all-time highs, rising employment and wages, and rising core inflation. Financing conditions are tightening, starting with the Fed. With U.S. growth, jobs, and equity markets largely going gangbusters, why would the Fed pause, or reverse...? It must get worse for the Fed to turn this around.

As a result, other than two in particular, we have made few noteworthy changes. First, we reduced our overall Argentina exposure. We are not changing our view on Argentina. In fact, we think the portfolio is in quite a virtuous position, having outperformed its benchmark by over 200 bps so far this year, despite having a large Argentina exposure (i.e., some might think it is easier to maintain the exposure as a result). The reduction is simply for prudent risk management reasons. Our Value at Risk (VaR) was large in Argentina and in an adverse overall market, greater diversification is advisable. The second change is that we increased our exposure to Korea. In our process, its fundamentals are so strong that even the seemingly low credit spread is actually high (relative to fundamentals). These bonds can also be very defensive and uncorrelated in EM turmoil.

Other than that, our main exposures remain. We continue to like...
Argentina in U.S. dollars, and are hedged on our smaller local currency exposure there. We like South Korea as it is cheap in our process, but also very defensive. We have China property names, after years of no China exposure because it was too expensive. But now property names are very “yieldy” and have high cash relative to short-term liabilities. We have Brazilian corporates that export to the growing U.S. economy and benefit from a weaker currency, which is hardly an endorsement of Brazil.

Regarding Brazil, Portfolio Manager Eric Fine recently returned from a week-long visit. In our view, there is some complacency on the risk of EM contagion testing Brazil at a time when it cannot respond effectively because of presidential elections in October. The elections’ outcome is very binary, with orthodox candidates translating into much stronger asset prices and heterodox candidates translating into much weaker asset prices. Right-winger Jair Messias Bolsonaro would be a very positive outcome, but might be short-lived due to implementation risks, whereas left-winger Fernando Haddad would be a very negative outcome, which might eventually be reversed as the need to prevent a crisis forces him into orthodoxy. Brazil’s strong external accounts may buy time for a new government to implement necessary social security reforms, but there is risk of capital flight in some scenarios that would undermine that one key strength (the country’s strong external position).

A final note: We have remarked in previous monthlies that we see the potential for greater divergence in EM debt fund performances. Part of this is simply due to turmoil which can create a wider range of outcomes. One key point we should emphasize, though, is that market structure and behavior are very different in EM now compared to previous decades. The asset class has grown so significantly and funds grown so large, that, while in the “old days” (the 80s, 90s, and noughts), when portfolio managers hated a credit, the response would have been not to own it—period, today, given the dynamic mentioned above, hating a credit often means “underweight”. This could be dangerous in an EM contagion, particularly for countries that are choosing not to respond properly, such as Turkey. There, for example, we see a real risk of capital controls. (You simply lose access to your asset...You can choose to mark it at screen prices, but that is simply a fictional mark in our opinion). We continue to believe that it is especially key to be index-agnostic in a risk-off or crisis environment.

Exposure Types and Significant Changes
The changes to our top positions are summarized below. Our largest positions are currently: South Korea, Argentina, China, Poland, and Brazil.

• We increased hard currency sovereign and quasi-sovereign exposure in South Korea. Our decision was driven by concerns about duration exposure in EM and by the fact that South Korea’s bonds have traditionally outperformed under this scenario. In addition, South Korea’s sovereign valuations look extremely attractive relative to the underlying fundamentals (our valuation framework points to the highest sovereign allocation). In terms of our investment process, this translated into the improved technical (correlation) score for the country.

• We further increased hard currency sovereign exposure in Egypt. Valuations continue to look attractive—especially against the backdrop of the improving credit metrics (reserves, debt/GDP, fiscal performance, etc.). The government continues to implement reforms agreed with the IMF and there are reports that the government’s new debt strategy will include limits on foreign borrowing. In terms of our investment process, this translates into the improved policy and technical scores for the country.

• Our hard currency corporate exposure in China (properties) also went up in the last month, but this reflected higher prices rather than any additional purchases. As a brief recap, our initial decision to get exposure to Chinese property companies was based on the fact that they consistently looked inexpensive in our valuation framework, compensating (in our view) for potential risks associated with possible government interference in the real estate sector. The companies that we eventually chose also had sufficient liquidity buffers to deal with potential moves to cool off the property market. We also think that the latest policy easing in China is likely to benefit the real estate sector as well.

• We reduced hard currency sovereign exposure in Argentina and local currency exposure in Argentina and Uruguay. In Argentina, sovereign assets remained under pressure as markets tried to figure out whether the new policy framework would be strong enough to withstand the deteriorating growth and inflation outlooks. A series of communication mishaps about financing on the part of Argentina’s authorities put the currency under tremendous pressure at the end of the month. Even though we hedged our local exposure in Argentina, the country’s policy and economic scores deteriorated enough to warrant a smaller position there. One of the reasons we decided to reduce our local exposure in Uruguay is the fact that the currency
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started to look very expensive relative to its regional neighbors (Argentina and Brazil), which translated into the worsening technical score for the country.

• We reduced hard currency sovereign exposure in Angola and Nigeria. In Nigeria, our target was to reduce the duration exposure (in our view, the correlation score for that part of the curve was deteriorating). In Angola, reducing the duration exposure was an important reason as well. However, we also noticed that the valuations for the short end of the curve started to look very unattractive, worsening the technical score for the country.

• We also reduced hard currency quasi-sovereign exposure in Venezuela following Crystallex’s victory in its “alter ego” case against Venezuela and Petróleos de Venezuela, S.A. (PDVSA), which capped the upside for PDVSA’s 2020 bonds at par. Meanwhile, future disputes and a potentially protracted legal process suggest that the downside can be significant given the current price level. In terms of our investment process, this worsened the technical score for the country (the policy and economic scores are deteriorating as well).

Fund Performance

The VanEck Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) lost -3.08% in August compared to a loss of a 3.91% 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 Dominican Republic, Chile, and United Arab Emirates. The Fund’s least contributors were Argentina, Nigeria, and Egypt. Turning to the market’s performance, the GBI-EM’s biggest winners were Thailand, and Romania. The biggest losers were Argentina, South Africa, and Romania. The EMBI’s biggest winners were Suriname, Vietnam, and Peru. The biggest losers were Zambia, Argentina, and Venezuela.

Average Annual Total Returns (%) as of August 31, 2018

<table>
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<tr>
<th></th>
<th>1 Mo†</th>
<th>3 Mo†</th>
<th>YTD</th>
<th>1 Yr</th>
<th>5 Yr</th>
<th>Life</th>
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<tr>
<td>Class A: NAV (Inception 7/9/12)</td>
<td>-3.08</td>
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<td>-5.91</td>
<td>-4.67</td>
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<td>0.61</td>
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<td>Class A: Maximum 5.75% Load</td>
<td>-8.65</td>
<td>-8.19</td>
<td>-11.35</td>
<td>-10.21</td>
<td>-0.53</td>
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<td>50 GBI-EM GD / 50% EMBI GD</td>
<td>-3.91</td>
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<td>-7.45</td>
<td>-6.67</td>
<td>2.15</td>
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Average Annual Total Returns (%) as of June 30, 2018

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<th></th>
<th>1 Mo†</th>
<th>3 Mo†</th>
<th>YTD</th>
<th>1 Yr</th>
<th>5 Yr</th>
<th>Life</th>
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<tr>
<td>Class A: NAV (Inception 7/9/12)</td>
<td>-2.78</td>
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<tr>
<td>Class A: Maximum 5.75% Load</td>
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<tr>
<td>50 GBI-EM GD / 50% EMBI GD</td>
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<td>-7.02</td>
<td>-5.78</td>
<td>-1.89</td>
<td>1.89</td>
<td>-</td>
</tr>
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†Monthly returns are not annualized.

Expenses: Class A: Gross 1.71%; Net 1.26%. Expenses are capped contractually until 05/01/19 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.
International Monetary Fund (IMF) is an international U.S.-based organization of 189 countries focused on international trade, financial stability, and economic growth.

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.

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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.