VanEck FUNDS

Back to the Fundamentals

By Eric Fine, Portfolio Manager

VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

Market Review

After a strong start to the year, we expect consolidation in EM debt because of: 1) macro tailwinds we cited in previous monthlies now becoming arguably discounted, 2) more evidence of de-rating in key EMs such as Mexico and South Africa, 3) adverse developments in key EMs such as Argentina and Poland, and 4) a "mixed bag" in other important EMs such as Brazil and Nigeria. Overall, we still see global macro tailwinds and, there are plenty of countries where we see opportunities. We simply remain concerned that the countries about which we are currently bearish (Mexico, South Africa, Turkey, Russia) happen to be big index components.

We still see the same global macroeconomic tailwinds from a neutered Fed, a stimulating China, and improved EM growth rates relative to DM, but these positives are now generally accepted by markets. Articles on the Fed "blinking" abound, and we got further confirmation of Fed dovishness in the form of Vice Chairman Richard Clarida saying that caps on bond yields are a policy option in future adverse scenarios. Modern Monetary Theory (MMT, which this author has been following for almost a decade) is now being debated in the media and as a serious policy option within the Democratic Party. In February, the US 10-year yield ground higher by about 10bps, indicating that these dovish developments are fully discounted. Chinese stimulus (even more fiscal measures were announced in February, amounting to a further % of GDP) is now in its second or third iteration since the weakness of 2018, depending on how one keeps score. This is also getting to be old news, in other words. EM relative growth improvements are still a noteworthy positive development for EM debt. Nonetheless, we incorporate growth positives on a country-by-country basis – we don't want beta in "EM" debt because "EM" growth is positive, we want exposure to countries with their own idiosyncratic growth dynamic. Our next paragraphs tell you that some of the major EMs remain under pressure on growth and other fronts, on the other hand.

We remain concerned about de-rating risks in Mexico and South Africa, which are large emerging market bond index components. Both countries were subject to adverse developments consistent with a de-rating story, and both continue to struggle with growth. In Mexico, S&P downgraded state-owned oil company Pemex's rating to B- from BB-, and the sovereign rating outlook was changed to negative from stable. And, the market is pricing in the central bank (Banxico) being more concerned about weak growth than about policy deterioration from the political side. We, on the other hand, see a still-orthodox central bank focused on inflation, worried about fiscal and structural deterioration, and worried about a weak peso translating into inflation and inflation expectations. A growth-save from Banxico seems questionable to us. We should also reiterate a point we made in previous monthlies that the overall stance of policy is shifting 180 degrees toward heterodoxy. When that comes to the fore is harder to predict, but it is a generally deteriorating story.

In South Africa, the country announced a new budget whose headline deficit increased to 4.7% of GDP from 3.9% in 2018, as a result of increased support to their state-owned energy company, Eskom (ie, similar to Mexico's Pemex situation). In this case, it appears that the changes in fiscal policy were designed to be just enough to stimulate, without triggering a Moody's downgrade below its Baa3 investment-grade rating (Moody's rating is the only remaining investment-grade rating on South Africa, and is keeping South African debt in key investment-grade indices, as we've explained in previous monthlies). But, growth and policy continue to deteriorate, and the policy direction from President Cyril Ramaphosa is murky going into elections, in our view. Eskom remains unresolved and it is unclear the government has the will to implement layoffs and other policies that would give hope that the bleeding is done. As a result, we see downgrades as inevitable as adverse data eventually shine through. Moody's seems to have set the stage for an eventual downgrade, actually, citing Eskom as a key risk to the country's fiscal problems and thus its rating, and has simply bought a few more months.

And, even countries about which we were heretofore constructive – Argentina and Poland – appear to be headed in the wrong direction. In Argentina, we've been constructive on bonds there essentially for 7 years, and are changing our view. The current bullish case depends on President Mauricio Macri getting re-elected in October elections, based on improved economic outcomes following the crisis, but those improved economic outcomes are not happening. Monthly inflation looks to be at 4% in February, a big acceleration from January, pointing to ongoing upside risks to inflation and a still-hawkish central bank. Growth is not turning as well in our opinion. Argentine industrial production suffered in December (down a massive 14.7% year-on-year), pressured by tight fiscal and monetary policies which look set to continue. Even the country's external accounts haven't improved as much as expected. January's trade balance surplus of $372mm was one-third of expectations. Investment weakness should be another headwind for growth. Moreover, Argentina remains the biggest overweight position in its history among dedicated EM investors, and we simply don't see how that position can hold without the bullish case we dismiss above transpiring.

Poland is seeing a potentially significant deterioration in fiscal policy that has shaken our constructive view. Going into October elections, the government has announced a huge fiscal stimulus package equal to an additional 1.3% to 1.8% of GDP. The measures are very consumption-oriented, and thus don't point to any increase in productivity as a result. Moreover, a lot of the measures are permanent, so this is not your garden-variety pre-election stimulus. This could mark a change towards less orthodoxy from a Poland that for decades has been a market stalwart. Finally, hawks at the central bank may choose to hike interest rates in March, as a result of stimulus.

There were some mixed-to-positive developments in Brazil and others, which rounds out the broadly cautious view we've laid out. In Brazil, pension reform has now been officially proposed, and is working its way through the legislature. The proposal is on the tougher side relative to expectations (i.e., higher retirement ages), but there were also early signs of concessions and a willingness to negotiate. Our point is that there's been progress, but no breakthrough as this process will likely take all of 2019. Please see our published reports on Brazil for more details. Other countries saw progress. Costa Rica passed a long-fought-over fiscal reform. Nigeria got through elections without contention. Ecuador approached the IMF for a funding deal (though details and commitment are unclear, in our view). Our general point is that we analyze "EM" country-by-country, are not married to indices/benchmarks, and that there are plenty of good EM bond market developments. For those for whom "EM debt" means Mexico and South Africa, the outlook could be problematic. However, there are plenty of opportunities for a bottom-up fund that doesn't track indices.

As a result of the above, we have reduced our exposures to Argentina and Poland, and continue to avoid Mexico, South Africa, Turkey, and Russia. Our Argentina exposure could continue to decline, in our view. This was/is a high-beta exposure so fund Value-at-risk has declined significantly. Similarly, we reduced our overweight exposure to Poland's local market. Without Mexico, South Africa, Turkey, and Russia, this means we are avoiding all of the big-index-weight, local-currency high-yielders other than Brazil. As a result, the fund was not dragged down by 1.09% decline in the GBI-EM, and preserved its year-to-date performance. Specifically, the fund was up 0.20% (I Share) in February, compared to a 1.09% drop in local markets and a 1.00% rise in hard currency. Following a January in which the fund was up (5.32%), roughly the same amount as the high-flying GBIEM (5.46%) in January despite not having exposure to those high-flyers, we remain comfortable avoiding these high-yielding but problematic countries, and focusing on bottom-up credits that get through our investment process.

Exposure Types and Significant Changes

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

- We increased our hard currency sovereign exposure in Nigeria and Uzbekistan. Uzbekistan was a first-time issuer, with excellent credit metric and valuations that looked cheap relative to the fundamentals. In Nigeria the re-election of President Muhammadu Buhari (by a wide margin) eliminated a major uncertainty, improving the country's political test score.

- We also increased our hard currency sovereign exposure in Jordan and Kenya. Long rates in both countries have excellent valuations relative to their respective fundamentals. In our view that should benefit from duration exposure. In terms of our investment process, the technical test scores look stronger in both countries.

- We also increased hard currency corporate and local exposure in Indonesia. We believe the country has very decent fundamentals and improved policies, and as such should be expected to rally together with the rest of emerging markets. In terms of our investment process, the technical test score for the country looks stronger.

- We reduced local currency exposure in Poland and hard currency sovereign exposure in Ukraine. In Poland, the government's unexpected and sizable pre-election fiscal package (which also appears to be long-lasting and focused mostly on consumption) can affect the budget and issuance trajectories. In terms of our investment process, this worsened the policy and technical test scores for the country. In Ukraine, the constitutional court's surprising decision to strike down a key anti-corruption law threatens IMF disbursements, worsening the country's policy and economic test scores.

- We also reduced hard currency sovereign and local currency exposure in Argentina. On the macro front, inflation appears to be more persistent than previously expected, and this necessitated a fairly sharp reversal in the central bank's interest rate direction (higher). On the political front, opposition candidates are doing better than anticipated in the polls. Together with the ongoing growth weakness, this affects the presidential election probabilities. In terms of our investment process, this translates into the worsening politics/policy and economic test scores for the country.

- We reduced hard currency sovereign exposure in Guatemala and hard currency corporate exposure in the Democratic Republic of Congo. Deteriorating valuations (and the worsening technical test score) was the main reason in Guatemala.

Fund Performance

The VanEck Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) gained 0.30% in February compared to a loss of 0.05% 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 Malaysia, Colombia, and Philippines. The biggest losers were South Africa, Argentina, and Turkey. The EMBI's biggest winners were Egypt, Costa Rica, and Ecuador. The biggest losers were Venezuela, Mozambique, and Argentina.

Average Annual Total Returns (%) as of February 28, 2019

	1 Mo†	3 Mo†	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	0.30	5.74	5.36	-2.28	0.30	1.28
Class A: Maximum 5.75% Load	-5.45	-0.39	-0.77	-7.93	-0.87	0.38
50 GBI-EM GD / 50% EMBI GD	-0.05	6.28	4.88	-1.18	2.78	2.39

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

	1 Mo†	3 Mo†	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	0.36	-1.99	-6.39	-6.39	-0.49	0.49
Class A: Maximum 5.75% Load	-5.46	-7.64	-11.81	-11.81	-1.66	-0.42
50 GBI-EM GD / 50% EMBI GD	1.33	0.43	-5.15	-5.15	1.95	1.70

†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.

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.

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.

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 and portfolio managers of other investment strategies may take an opposite opinion than those stated herein. Not intended to be a forecast of future events, a guarantee of future results or investment advice. Current market conditions may not continue. Non-VanEck proprietary information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

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 below investment grade securities, credit, currency management strategies, debt securities, derivatives, emerging market securities, foreign currency transactions, foreign securities, hedging, other investment companies, Latin American issuers, management, market, non-diversification, operational, portfolio turnover, sectors and sovereign bond risks. 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, and the risk that a position could not be closed when most advantageous. The Fund may also be subject to risks associated with non-investment grade securities.

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.