Manager Commentary

Tailwinds and Headwinds in Emerging Markets Debt

By: Eric Fine, Portfolio Manager

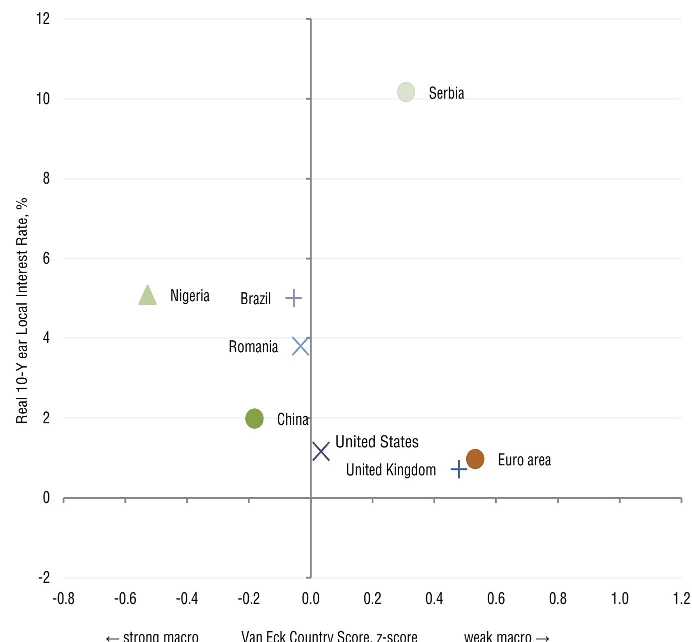
Executive Summary

- Real interest rates and credit spreads are high in a number of emerging markets.
- Even some countries with unimpressive overall policy frameworks have allowed currency weakness and hiked interest rates.
- Rising growth levels in developed markets continue, however, to attract money away from emerging markets.

Overview

Let's start with a tailwind: real interest rates and credit spreads currently are high in a number of emerging markets (EM). The charts below show a sampling of EM real interest rates and credit spreads compared with a sampling of developed markets (DM) real interest rates and spreads (on the y-axis). On the x-axis is our country score. (This is not too different from a credit rating: our inputs are variables such as the country's balance of payments accounts, fiscal accounts, financial sector health, etc.). The point of these charts is that, in our opinion, one generally gets paid more for EM risk than for the same level of DM risk.

Exhibit 1: Real Rates and Country Score: EM versus DM



Source: Bloomberg, Van Eck research. Data as of January 31, 2014.
Z-score is a statistical measure of how close a data point is to a data set's mean.

Another tailwind: EM policy has responded, and much of the policy response is a "simple" function of flexible exchange rate regimes, not really requiring politicians to be pro-active or even to take "action". To explain. In the first phase of the EM mini-crisis that started in May/June of 2013, the market focused its (negative) attention on countries with large current account deficits. The immediate response of policymakers in Brazil, India, and Indonesia was, technically…nothing. Flexible exchange rate regimes mean that if the market chooses to be concerned about external imbalances, the currency adjusts – period. (We're simplifying, but, we believe, not too much.) Imports are curtailed (which is, in our experience, the normal and more dramatic initial effect), and, as a result, exports are potentially boosted.

Now, in some countries, inflation memory exists, so weak currencies can potentially feed through into rising inflation expectations. So, a logical follow-on policy may be higher interest rates. This has tended to stabilize the currency (ceteris paribus), encourage savings, and slow the economy down…reducing inflationary pressures, as well as imports. Even countries whose overall policy frameworks do not impress us, and which we do not own – Turkey, South Africa, Ghana, to name a few – have adjusted to the market's concerns and allowed currency weakness and hiked interest rates. (However, in our opinion, just not enough.)

Even supposedly heterodox Argentina has been forced by the market to allow greater currency weakness and has allowed much higher domestic interest rates…perhaps the best policy we've seen from the country in many years. In particular, the currency has been allowed to sell off by 20% since the beginning of the year, and interest rates (as measured by the central bank's Lebac bills) have risen by 900 basis points. This combination is very powerful, in our opinion, for the reasons explained above. After these moves, the country could potentially begin to see an increase in hard-currency reserves at the central bank. Moreover, it appears to be freeing up frozen resources in the agriculture sector. Farmers are estimated, by local analysts, to have up to $4 billion worth of unsold soybeans. Before the adjustment in the exchange rate, their thinking may have been: "We'll wait 'til we can get more pesos for our beans because we think the peso is too expensive." After the currency adjustment, their thinking appears to have been: "We'll wait because we think you'll have to devalue more." After the rise in interest rates, however, the response looks to be: "We'll sell our beans because we can now put our peso proceeds into peso bonds with high yields." The country's cabinet chief recently announced that soybean farmers have committed to sell $2 billion of soybeans as a result of these moves, which would further boost reserves.

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.

One key headwind remains that the DM, particularly the US, is experiencing rising growth levels, whereas the EM is experiencing lower growth. This could attract money away from the EM and into the DM. EM debt and equity markets have seen outflows every week so far this year – dramatically so in equities. Moreover, the "good" policy we praise above may preserve reserves and keep the balance sheet strong. But it does hurt growth, exacerbating this money flow.

Another key headwind is that the EM debt market community may not be as aware of corporate borrowing activity as it should be. Key countries may have more corporate debt in hard-currency than conventional econometrics would indicate. Traditionally, market participants use national central bank balance of payments data to determine corporate debt issuance. The standard practice for central banks has been not to count corporate debt issued by an overseas subsidiary of a domestic company. (You might recall this issue arising in the European debt crisis, when Irish debt turned out to be much larger than commonly understood, because much of it was bank debt issued offshore in, say, Luxemburg, and which was accounted for as Luxemburg debt). Anyway, this issue is now getting more attention (Lord Turner of the Bank for International Settlements has written a recent paper on the topic), and rightly so.

Exposure Types and Significant Changes

As an ongoing reaction to these developments, we continued to do two things in the portfolio – diversify and increase exposure to hard-currency debt (and, thus, reduce exposure to local-currency debt). We never really got to the "So what?" of our point above that some EM countries have allowed currency weakness and hiked interest rates. The "So what" is that this protects hard-currency reserves that are used to pay hard-currency debt.

Our top five positions are currently: Argentina (in hard-currency), Brazil, Hungary, Mexico, and Indonesia (all in a mix of hard- and local-currency). Our top five country allocations are identical to last month's, with the exception of Sri Lanka (which we reduced) and Indonesia (which we increased). The bigger point, though, remains that we continued to reduce our local-currency exposure and raise our hard-currency exposure.

Biggest Country- and Bond-Level Changes

- We increased hard-currency debt to 59% of AUM from 47% last month.
- We diversified the portfolio into a wide range of hard-currency bonds. Among them are Romania, Belarus, Serbia, Guatemala, Angola, Vietnam, and Russia.
- Although our top five country exposures were largely unchanged, Brazil, Hungary, Mexico, and Indonesia all saw reductions in local-currency exposure and increases in hard-currency exposure.

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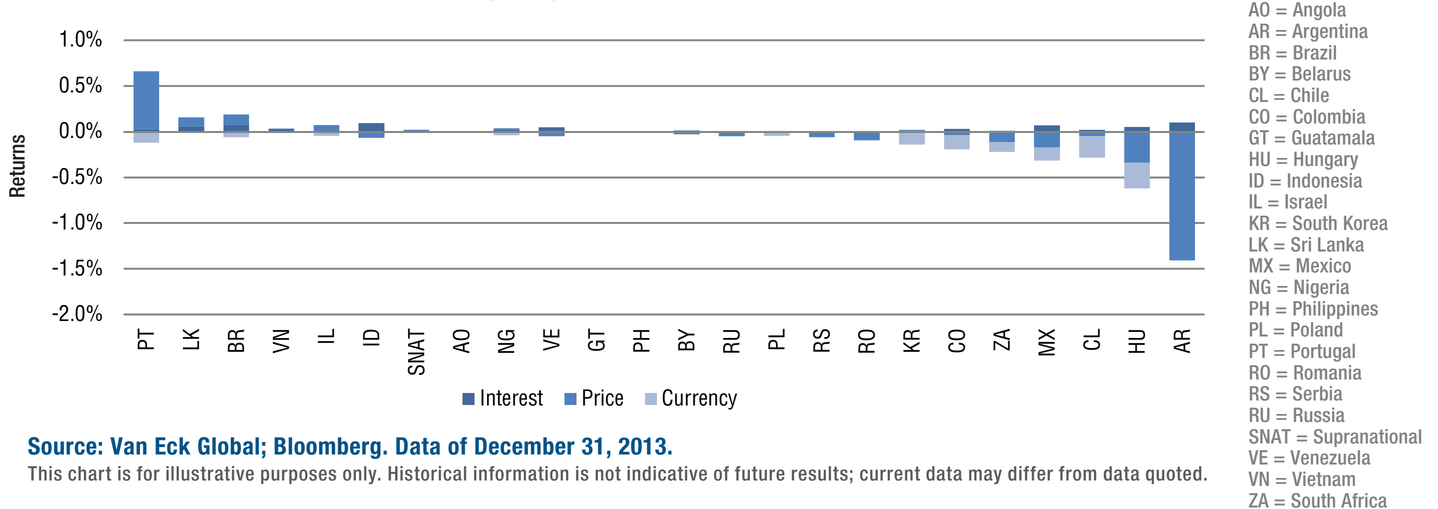
Fund Performance

For December, the Fund's Class A shares at NAV returned -1.98%, compared to -4.63% in the local-currency index (GBI-EM Index), and -0.68% in the hard-currency index (EMBI Index). The Fund's biggest winners in January were Portugal (hard-currency), Sri Lanka (local-currency), and Indonesia (local-currency). The Fund's biggest losers were Argentina (hard-currency), Hungary (local-currency), and Chile (local-currency).

The market's best performers during the past month were Belize, Jamaica, and Egypt in hard-currency, and China, India, and Thailand in local-currency. The markets' worst performers of the past month were Argentina, Venezuela, and Ukraine in hard-currency, and South Africa, Russia, and Hungary in local-currency.

Price, Interest and Currency ("FX") Components of Fund Returns by Country for December 2013



Source: Van Eck Global; Bloomberg. Data of December 31, 2013.

This chart is for illustrative purposes only. Historical information is not indicative of future results; current data may differ from data quoted.

Average Annual Total Returns (%) as of January 31, 2014

	1 Mo*	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	-1.98	-1.98	-9.58	2.37
Class A: Maximum 5.75% load	-7.60	-7.60	-14.79	-2.21
GBI-EM Index	-4.63	-4.63	-13.81	--
EMBI Index	-0.68	-0.68	-4.62	--

Average Annual Total Returns (%) as of December 31, 2013

	1 Mo*	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	0.54	-4.70	-4.70	3.91
Class A: Maximum 5.75% load	-5.22	-10.16	-10.16	-0.15
GBI-EM Index	-0.55	-8.98	-8.98	--
EMBI Index	0.51	-5.25	-5.25	--

Expenses: Class A: Gross 1.67%; Net 1.25%. Expenses are capped contractually until 05/01/14 at 1.25% for Class A. Caps exclude certain expenses, such as interest. 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 applicable 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 investor's 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 NAV. Index returns assume that dividends of the Index constituents in the Index have been reinvested. All investments contain risk and may lose value; please see disclaimers on next page.

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.

Data Source: Van Eck Research, Factset. All portfolio weightings and statements herein as of January 31, 2014.

Emerging Markets Hard Currency Bonds refers to bonds denominated in currencies that are generally widely accepted around the world (such as the US Dollar, Euro or Yen). **Emerging Markets Local Currency Bonds** are bonds denominated in the local currency of the issuer. **Emerging Markets Sovereign Bonds** are bonds issued by national governments of emerging countries in order to finance a country's growth. **Emerging Markets Quasi-Sovereign Bonds** are bonds issued by corporations domiciled in emerging countries that are either 100% government owned or whose debts are 100% government guaranteed. **Emerging Markets Corporate Bonds** are bonds issued by non-government owned corporations that are domiciled in emerging countries. A **Supranational** is an international organization, or union, whose members transcend national boundaries and share in the decision-making. Examples of supranationals are: World Bank, IMF, World Trade Organization.

Any indices listed are unmanaged indices 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 J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM) tracks local currency bonds issued by Emerging Markets governments. The index spans over 15 countries. The J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI) 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. The Barclays U.S. Aggregate Bond Index is a market capitalization-weighted index representing most U.S. traded investment grade bonds. The index comprises government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturity of the bonds in the index are over one year. The CBOE Volatility Index (VIX) uses options on S&P 500 Index stocks to gauge expected or implied volatility and is widely used as a measure of risk in the equity market.

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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, and charges and expenses carefully before investing. Bond and bond funds will decrease in value as interest rates rise. The prospectus and summary prospectus contain this as well as 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.

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