VanEck FUNDS

The end of quantitative easing in sight

By Eric Fine, Portfolio Manager

VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

Market Review

After having, on average, half of the portfolio's exposure in emerging markets local currency-denominated debt throughout this year, the Fund is now undergoing a shift to lower local currency exposure. The reductions in exposure have been due to country-specific phenomena. The best example is the unloading of our Brazilian real bond exposure beginning two months ago. This was covered extensively in our last monthly, but the reasons were due to Brazil-specific reasons: politics, the country's deteriorating debt dynamic, and a consensus overweight in the market.

Another development that has pushed us in the direction of lower local currency exposure, through our investment process, is the decline in oil prices. The decline in oil prices, in our opinion, reflects a market that is trying to discover a new equilibrium in a world of lower-cost and atomized production from shale in the U.S. and other factors. We don't have an explicit view on oil prices, and in fact try to purge any view from our investment decisions – we don't invest in emerging markets bonds based on an oil price view, we invest when we do not see oil price risk as central to the investment. What has happened is that we now think oil is important to a number of exposures we had and have. In particular, oil prices have declined significantly, without a commensurate decline in a number of oil-sensitive asset prices. The Russian ruble and Colombian peso, in particular, had outperformed oil prices significantly at the time we reduced those positions. Steps one and two of our investment process indicate that these bond markets pay high real interest rates relative to their fundamentals. However, one of the three tests in step three of our process is the correlation test. The ruble and Colombian peso had outperformed oil significantly on a 12-, 6-, and 3-month trailing basis (as of early-June when we started to make our portfolio adjustments). Put differently, we see a risk that these asset prices do not benefit from any stabilization in oil prices, and might catch-up and underperform significantly if oil does not stabilize. This outperformance has led us to reduce our exposure in both Russian ruble and Colombian peso bonds. One might conclude that because we have less local currency exposure we are therefore less "bullish" about the emerging markets debt market. Our conclusion is different, and is simply that our process guided us to reduce risk in those two specific asset prices as they are at risk of re-correlating with oil, nothing more than that.

There is one more thing that is more firmly on our radar, which might lead us to further reductions in not only local currency exposure, but also duration – tighter policy from the U.S. Federal Reserve (Fed) and the European Central Bank. Both institutions are signaling ends to their balance sheet expansions, which included long-dated risky bonds. This change in policy may give one pause to wonder about the impact of such moves. Our more specific concern is that, in our opinion, the market seems to be massively discounting Fed communications. Not only did the 30-year U.S. Treasury bond rally after the latest Fed interest rate hike and communication that was widely viewed as hawkish, but the overall rejection of the Fed's "dot-plot" is magnifying. In particular, the market is pricing roughly 180 bps less in Fed rate hikes over 2018 and 2019 than the Fed's mean projections. Moreover, Fed communication is more clearly focused on tightening financial conditions – the Fed is basically talking markets down, perhaps due to fears of asset-price bubbles or even in reaction to the market essentially saying "we don't believe you" or "we don't believe you will be able to follow through on tightening, because you'll cause a recession". One doesn't need a lot of training in game theory to see how fraught such a situation can become before resolution.

Even Fed economists are hyper-aware of the Fed tightening, widely viewed as mistaken, in 1937. But that concern seems to have disappeared dramatically following the U.S. election. If the Fed is serious about hiking and about tightening financial conditions (which, we should remind you, includes a stronger U.S. dollar), at a minimum there will likely be a "battle" between the Fed and the market, and if the Fed "wins", it risks making a policy error and triggering a recession.

We have, of course, noted before how correlated U.S. interest rates are with those of other developed bond markets such as Japanese government bonds, German Bunds, and U.K. Gilts. This will likely not be a contained phenomenon. Our point is that this risk is now on our radar, and points in the direction of lower duration and potentially even a stronger U.S. dollar. We should emphasize, though, that the way we will look at this is via our process, which (as with the oil example above) will not be based on a central case view for U.S. interest rates, but will, instead, ask whether specific emerging markets asset prices are reflecting way too low a probability of pressure from such a scenario.

An illustrative example might be long-duration Argentine bonds where we see enough idiosyncrasy, spread, and technical support that we'd be surprised if U.S. rates became a big driver in the coming month or so. Long-dated Mexican local bonds, on the other hand, are less idiosyncratic and more correlated with U.S. Treasuries. So there could be some impact there. In any case, we are tee-ing this issue up, and emphasizing that our process could generate more cautious judgements on asset prices that will be conducted on a country by country basis, not across the board.

This is not to say that the other issues we've highlighted in our monthlies and other publications have disappeared. In particular, we are still very concerned about continuing bullish positioning in Brazil, where we see deteriorating politics and policy in the face of a deteriorating debt dynamic. A slowing U.S. or global economy is another ongoing focus. China's economic and financial path also remains in the mix. Our main point is that a potentially more hawkish than expected Fed is worth focusing on.

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions are: Argentina, Mexico, Ukraine, Peru, Israel, and Uruguay.

- We increased hard currency sovereign exposure in Argentina and Belarus. Both countries have an attractive combination of high spreads and idiosyncratic drivers, as well as good technical support. Besides, the latest political developments in Argentina might improve the Macri movement's chances in the forthcoming mid-term elections. In terms of our investment process, the correlation scores for these countries look stronger.

- We increased local currency exposure in Mexico and Poland. Poland's "goldilocks" macro environment – very robust growth and low inflation pressures – provides fundamental support for the currency while giving the central bank room to stay on hold for now. In Mexico, it appears that inflation is peaking and the Banxico should be in a position to start easing in the second half of 2017. In terms of our investment process, this translates into the improved correlation scores for these countries.

- We increased hard currency sovereign exposure in South Korea, Chile, and Israel, as well as hard currency quasi-sovereign exposure in Israel and Peru. South Korea and Israel are good diversifiers in a scenario under which market expectations would have to catch up with the Fed's normalization path. In South Korea, we have an extra boon in the form of the improved sovereign valuation that also boosted the country's correlation score.

- We reduced local currency exposure in Russia, Romania, South Africa, and Colombia. In Russia and Colombia we saw disconnect between the currencies and the falling oil prices which weakened the correlation scores for these countries. The policy/politics scores in all three countries also took a hit – concerns about South Africa's institutions (the new mining charter, the South African Reserve Bank mandate), the extension of sanctions in Russia, and a weaker fiscal framework in Colombia.

- We reduced hard currency sovereign exposure in Angola, the Dominican Republic, and Ecuador, and hard currency corporate exposure in Russia. In Angola and Ecuador, the recent oil price drop was not fully reflected in valuations. An additional consideration for Ecuador is that there might be more need for bond issuance if the price of oil remains low. In the Dominican Republic, our main concern was over the impact of the Fed's hawkishness and the balance sheet reduction on risky assets and duration (we owned a very long bond). In terms of our investment process, this translated into the worsening correlation scores for these countries.

Fund Performance

The VanEck Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) gained 0.81% in June, compared to 0.16% 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 Uruguay, Mexico and Belarus. The Fund's losers included Colombia, Russia and Romania. Turning to the market's performance, the GBI-EM's biggest winners were Mexico, The Philippines and Brazil. The biggest losers were Czech Republic, South Africa and Chile. The EMBI's biggest winners were El Salvador, Pakistan and Namibia. The biggest losers were Venezuela, Iraq and Mozambique.

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

	1 Mo†	3 Mo†	YTD	1 Yr	3 Yr	Life
Class A: NAV (Inception 7/9/12)	0.81	1.83	7.34	6.49	-2.98	1.18
Class A: Maximum 5.75% Load	-5.02	-4.03	1.21	0.42	-4.87	-0.01
50 GBI-EM GD / 50% EMBI GD	0.16	2.93	8.26	6.26	1.28	–

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.

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. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission of Van Eck Securities Corporation ©2017 VanEck.

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.

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