VanEck®

VanEck® FUNDS

Synchronized Global Growth in Jeopardy

By Eric Fine, Portfolio Manager

VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

Market Review

The buzzwords of 2017 – "synchronized global growth" – might be coming to an end, raising a new risk for emerging markets. Having resisted any possibility of positive economic outcomes under U.S. President Trump's economic policies, market growth forecasts began to rise in 2017. A lot of the recent growth underperformance may be due to excessively optimistic forecasts, in other words. The Eurozone has been generating adverse economic surprises, in particular, with data surprises now as negative as they were during the crisis in the European periphery. The market also seems to be treating Eurozone data deterioration as transitory. The Euro has been rallying into this deterioration of economic conditions, meaning that the pain trade[1] is likely to be further tests of the Euro in the event that this economic weakness is temporary. This undermines one of the key global economic and asset-price drivers of 2017.

In addition, China's economic data are mixed and distorted (especially due to seasonal factors and inventories) in January/February. So to us, that translates into a bit of a blind spot, as the real economic trend only becomes apparent in March and beyond. Commodity price declines, combined with weaker domestic equities and lower interest rates are consistent with challenges to Chinese growth.

Tighter global financing conditions are another element of this challenge to global growth with rising short-dated U.S. interest rates having sold off dramatically, and Libor discussions (and their impact on borrowers, and ultimately the U.S. dollar) dominating mainstream financial media discussions. But there are risks – higher inflation being the key. The inflation surprise indices in the U.S. and Japan are once again rising, while those in emerging markets and the Eurozone are no longer falling. A combination of higher inflation and stronger growth prospects is likely to push global nominal yields higher. This will be especially true if the situation with abnormally low term premia in the developed markets (still negative for 10-year U.S. Treasury yields!) starts turning. This is not an unreasonable assumption/expectation given that major central banks are considering (or already) withdrawing policy accommodation, which is set to increase net government bond issuance. Last (but not least), the widening twin deficits in the U.S. might also contribute to higher nominal yields – the historic relation between the two is quite strong. This year's "volmageddon"[2] and ongoing weakness in global equity indices, which emerging markets local currencies in particular have resisted, makes emerging markets risk a reasonable candidate for catching up to broader market weakness.

Despite this increase in risk, though, our basic conclusions and positions remain unchanged. Most elements of our views remain intact, despite the challenges to global growth. As of now, the consensus for global growth forecast in 2018 remains steady at 3.7%, while the JP Morgan Global Composite PMI[3] is grinding higher (very healthy 54.8 in February). Stronger global demand is generally supportive of emerging markets fundamentals.

Given the backdrop of risks to global growth, stretched asset price valuations are reasons to be cautious and selective, but that is also not a new stance for us. The EMBIG spread is close to the 5-year lows, and the GBI-EM rallied back to the post-taper tantrum[4] highs. The emerging markets local debt risk premia (measured as emerging markets local interest rates spreads over the U.S., adjusted for emerging markets credit spread) continue to push lower: the 10-year risk premium is now the lowest since late-2013, while 2-year and 5-year risk premia are the lowest since 2011.

One conclusion from this has been to maintain low duration, and this continues. Risk-free duration is challenged by ongoing global growth, and especially by rising inflation pressures in the U.S., Germany, and now Japan. Credit spread duration is challenged by stretched valuations, as well as the many risks to global synchronized growth – outflows from bonds, accelerated monetary tightening, and the risks that come when rates rise following increased debt. We expected and continue to expect upward pressure on interest rates and thus maintain low duration.

Another conclusion is to favor idiosyncrasy. In hard currency, we prefer bonds and credits whose outcomes are not mostly driven by the global macro crosswinds buffeting asset prices. These names have higher spreads and spread-to-yield ratios, improving fundamentals, and – preferably – strong policy anchors in the form of International Monetary Fund (IMF) programs (aspirations work as well in some cases). Our current exposures include such diverse names as Armenia, Belarus, El Salvador, Mongolia, Ukraine, and Venezuela. All of these bonds are short-duration (2023 is the longest one) and have strong idiosyncratic drivers. The IMF programs are important factors in Ukraine and Mongolia. In the former, the government can count on receiving one more tranche in the second quarter of the year, while in the latter the government and the IMF have just reached a staff-level agreement on the third review of the EFF[5] facility. Belarus has managed to find the geopolitical "Golden Middle" in its relations with both Russia and Europe, while fostering growth, maintaining fiscal discipline, and rebuilding its international reserves. The Armenian economy is in turnaround mode growth-wise and this should help to reduce macroeconomic imbalances (current account and fiscal gaps).

As regards local currency, we continued to increase our exposure in March, bringing it to about 60% of our portfolio. There are several reasons for this. First, the risk of rising rates had been mostly addressed in a number of countries – and this includes policy adjustment. Second, many emerging economies are still relatively early in the business cycle, with no need to tighten the policy stance (despite the impending stimulus withdrawal in developed markets). Real rates for countries in the GBI-EM local currency bond index generally have high real interest rates relative to history. Third, we see quite a few countries where policy makers are maintaining high real interest rates which can cushion the risk of rising global interest rates. Finally, the outlook for the U.S. dollar remains uncertain despite the Federal Reserve's (Fed's) policy normalization. On the one hand, the differential between expected interest rates in the Eurozone and the U.S. is no longer widening and this should limit the dollar's downside – if the trend continues.

On the other hand, the widening twin deficits in the U.S. are often associated with the dollar's weakness. We believe that this U.S. dollar backdrop leaves enough room for idiosyncratic plays in the emerging markets foreign exchange space. With all this in mind, we selected the following countries for our local debt exposure: South Africa, Poland, Russia, Mexico, Brazil, Chile, Argentina, Colombia, the Dominican Republic, and Indonesia.

Brazil, Mexico, and Russia merit some additional attention (we focused on our top exposure, South Africa, last month). We have an underweight position in Brazilian local currency. This is due to disappointing growth outcomes. Moreover, the political outcomes as we approach this year's presidential elections could involve populist candidates markets are often concerned about. And, the government is facing a deteriorating debt dynamic and large ongoing fiscal deficits (around 10% of GDP). Mexico is interesting because it isn't. After being buffeted by NAFTA[6] concerns that abated, the next risk was domestic politics, with locals particularly concerned over a populist leftist's (Andres Manuel Lopez Obrador – AMLO) gains in polls. But AMLO's rise is looking more and more like old news. And the country's fundamental backdrop is excellent, in our opinion, as discussed in earlier commentaries.

Exposure Types and Significant Changes

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

- We increased local exposure in Mexico. We now have a favorable combination of the improved NAFTA outlook and a more established disinflation trend which might allow the central bank to start policy easing in the coming months. In terms of our investment process, this translates into the improved policy/politics score.

- We increased local exposure in Uruguay. Valuations improved significantly in the past few months (on the back of a major sell-off), while the short-term macro outlook remains supportive. Specifically, the government remains committed to meeting its 2018 fiscal targets, the growth outlook is fine with no signs of overheating, and inflation expectations stay close to the target band ceiling. In terms of our investment process, this translates into the improved vulnerability score.

- We increased local sovereign and hard currency corporate exposure in Argentina and quasi-sovereign hard currency exposure in Venezuela. Even though Argentina is not yet out of the "inflation woods", the policy framework looks stronger. There will be no more rate cuts until the central bank sees sustainable improvements

in inflation and inflation expectations, gradual fiscal consolidation continues, and the government is moving forward on the structural reform front. In terms of our investment process, this improved the country's policy/politics score. In Venezuela, there are signs that a presidential candidate Henri Falcon is getting more support from the opposition, which translates into the improved policy/politics score for the country.

- We reduced hard currency corporate exposure in Brazil and Indonesia. Comments by the management of Rumo (Latin America's largest independent rail-based logistics operator) in Brazil regarding the likelihood of increased issuance led us to sell our position as we became worried about the possible negative effects on pricing. In Indonesia, our concerns grew somewhat as the government set a ceiling on coal prices that companies are obligated to sell domestically. As a result, we took profits on one position, that company most affected by those changes, and sold the weakest credit of our corporate holdings in that industry.

- We also reduced quasi-sovereign hard currency exposure in Ecuador. The direction of reforms in Ecuador looks less clear after the appointment of the new minister of finance and revelations that there might be additional loans that are not covered by the official statistics worsen the country's vulnerability and policy/politics scores.

- We also reduced local currency exposure in South Africa and Chile. South Africa's local bonds no longer look cheap relative to fundamentals, while a lot of positive news on the political/policy/ratings front has already been priced in. Further, the central bank turned out more hawkish at its last policy meeting – signaling that the policy rate cut might be "one and done" and that the currency looks overvalued. In terms of our investment process, this translates into the worsening vulnerability score for the country. Chile's macroeconomic backdrop improved significantly after the presidential elections, however local bonds valuations look less compelling now relative to fundamentals. This worsens the vulnerability score for the country.

Fund Performance

The VanEck Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) gained 1.72% in February compared to a gain of 0.66% 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.

[1]A pain trade is "[t]he tendency of markets to deliver the maximum amount of punishment to the most investors from time to time. A pain trade occurs when a popular asset class or widely followed investing strategy takes an unexpected turn that catches most investors flat-footed." https://www.investopedia.com/terms/p/pain-trade.asp

[2]The explosion in market volatility in early 2018.

[3]CME Group: "JP Morgan Global Composite PMI gives an overview of the global manufacturing and services sectors. It is based on monthly surveys of over 16,00 purchasing executives from 32 of the world's top economies, including the U.S., Japan, Germany, France and China which together account for over 85 percent of global GDP." http://www.cmegroup.com/education/events/econoday/2018/03/feed488104.html

[4]"Taper tantrum is the term used to refer to the 2013 surge in U.S. Treasury yields, which resulted from the Federal Reserve's use of tapering to gradually reduce the amount of money it was feeding into the economy." https://www.investopedia.com/terms/t/taper-tantrum.asp

[5]IMF Extended Fund Facility (EFF): "When a country faces serious medium-term balance of payments problems because of structural weaknesses that require time to address, the IMF can assist with the adjustment process under an Extended Fund Facility (EFF)." http://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/20/56/Extended-Fund-Facility

[6]North America Free Trade Agreement

The Fund's biggest winners were South Africa, Indonesia and Argentina. The Fund's losers included Brazil, Dominican Republic, and Venezuela. Turning to the market's performance, the GBI-EM's biggest winners were Mexico, Colombia and Hungary. The biggest losers were Turkey, Russia and the Philippines. The EMBI's biggest winners were Venezuela, Ethiopia and Lebanon. The biggest losers were Mozambique, Jordan and Pakistan.

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

	1 Mo†	3 Mo†	YTD	1 Yr	3 Yr	Life
Class A: NAV (Inception 7/9/12)	1.72	2.66	2.66	8.77	2.08	2.19
Class A: Maximum 5.75% Load	-4.17	-3.28	-3.28	2.51	0.08	1.15
50 GBI-EM GD / 50% EMBI GD	0.66	1.33	1.33	8.61	5.68	–

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

	1 Mo†	3 Mo†	YTD	1 Yr	3 Yr	Life
Class A: NAV (Inception 7/9/12)	1.16	-0.24	11.68	11.68	0.78	1.81
Class A: Maximum 5.75% Load	-4.71	-5.99	5.30	5.30	-1.20	0.71
50 GBI-EM GD / 50% EMBI GD	1.38	1.01	12.74	12.74	4.87	–

†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 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.

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 indicies may take into account witholding 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.

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.