VanEck FUNDS

# Brazil Takes a Turn for the Worse

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## VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

### Market Review

An important development in the emerging markets debt space, as well as in our portfolio, concerns Brazil. Generally, Brazil has been witnessing strong and improving external accounts, with the current account and foreign direct investment (FDI) surprising on the upside. Add to this an independent central bank that is maintaining high real interest rates while anchoring inflation expectations. This generally is a recipe for a good investment opportunity. However, the problem is, and has been, the country's deteriorating debt dynamic, which is generated by the country's whopping 10% of GDP fiscal deficit. This is why we, and the market, have been closely watching the government's efforts to get votes for its social security reform program.

In our opinion, the new corruption allegation against President Temer and/or his close associates is a major setback for several reasons. First, Temer was unable to generate enough legislative support before the latest crisis, and at a minimum this delays approval of reforms until August. Second, the basic game theory seems to point towards an unraveling of support for reform. Most simply, the majority of the population in Brazil view the current president, any potential replacement, and the legislature as corrupt…and now their key initiative is to increase the population's retirement age? We don't see how a coalition can be maintained under those conditions. Governability might be difficult at best. Third, the asset price implications seem asymmetric to us, with more downside (in the event of no reform approval) than upside (in the event of approval). The reforms have been a market consensus. Most market participants believe that reforms (in some acceptable form) will be approved.

As a result of the assessment that reforms are fully priced-in and we saw no upside in the event of their passage, we sold the bulk of the Fund's Brazil position, including all of our higher-beta local currency exposure, before the latest scandal. We unloaded the remaining exposure (all in hard currency) following the breakout of the bribery allegations. For now, we see no upside from investing in the country's debt but we will keep an open mind and act if we see improvement.

Moving on from Brazil, our basic constructive stance remains. The global growth environment looks generally supportive. The latest Developed Markets PMIs point to a moderate and steady expansion in the coming months (both services and manufacturing PMIs are hovering around 54.0) with risks in Japan and the Eurozone probably to the upside. We are keeping an eye on the recession probability in the U.S., which has been rising lately (again) as the U.S. Treasury curve has flattened. But it remains quite low by historic standards and the U.S. economy is expected to expand by just over 2% in both 2017 and 2018. Against this background, inflation pressures on both sides of the Atlantic remain well contained with the near-term risk of deflation virtually non-existent, and signaling that the policy tightening is likely to be very gradual. It is worth noting in this regard that monetary policy tightening in the U.S. was often bullish for risk assets as long as it was associated with rising demand.

In emerging markets, the growth outlook also looks stable for now despite the recent slippage in the emerging markets manufacturing PMIs. Emerging markets should benefit from the fact that the anti-trade/protectionism rhetoric of the Trump administration has quieted down. Many emerging markets central banks are still in an easing mode, supporting the recovery process and responding to lower inflation and inflation expectations. This allows real rates to remain high and currencies supported.

The political situation in the Eurozone looks a bit more stable in the aftermath of the French presidential elections. The first round of the French parliamentary elections suggests that President Macron might end up with much stronger support in the lower house, which should allow him to move more aggressively on labor market reform (and potentially several other structural changes). Even in Italy – one of the weakest links in the monetary union from the structural point of view – the local election results suggest that support for the anti-euro party (Five Start Movement) might not be as strong as earlier polls suggested.

China's slowdown is manageable for now and the immediate risks associated with the international reserves depletion appear contained (mostly due to the imposition of capital controls). Chinese authorities continue to keep the stimulus spigot open pump-priming growth through "official" channels. These trends create a supportive background for Chinese Yuan (and hence for EMFX in general) - even though tighter liquidity conditions is an important driver pushing the currency stronger at the moment.

These factors help to explain why we feel comfortable having approximately 50% of our portfolio in emerging markets local-currency denominated bonds. Our biggest positions are in Argentina, Colombia, Mexico, Russia, South Africa, and Uruguay. Colombia, Russia, South Africa, and Uruguay are genuine disinflation stories - still, central banks prefer to keep real policy rates high until low inflation and inflation expectations become well-entrenched. The improving/strong external balances in these countries strengthen fundamental support for the currencies. Mexico is finally getting close to the point where inflation will be topping out (aided by the Banxico's tight monetary policy stance). The outcome of the State of Mexico elections and stronger than expected activity indicators are extra boons both for the Mexico peso and rates. Argentina is a more complicated case - but the inflation turnaround might be finally in sight and the central bank has enough strength and conviction to keep the policy rate sufficiently high despite the output costs.

In the past month, we also added local exposure in Poland and Romania in order to benefit from a more benign European story through higher yielding instruments. We also like Poland's "goldilocks" fundamentals (real GDP growth of 4% and headline inflation below 2%) and a more stable political environment, which reduces pressure on the National Bank of Poland (NBP) to tighten while providing enough support for the currency.

Our hard currency holdings remain well-diversified. There are several fairly concentrated positions in Argentina, Ukraine, and Ecuador. In Ukraine, the expectation is that the government will need to address key structural reforms (pension and land) in the process of getting the next two IMF tranches. In Ecuador, the new president is essentially implementing elements of an IMF program without the IMF (due to the political baggage the IMF brings to a "leftist" government). We also have exposure to a number of higher-yielding sovereign names in Africa (Angola, Senegal, Kenya, Nigeria, and Rwanda) and Latin America, which we believe have supportive/idiosyncratic storylines.

## Exposure Types and Significant Changes

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

- We increased hard currency quasi-sovereign and corporate exposure in Ukraine, hard currency sovereign exposure in Peru, and hard currency corporate exposure in Mexico. In Ukraine, we believe that the government will need to address further structural issues in the process of getting the next IMF tranche. In terms of our process, this results in the improved policy/politics score for the country. In Mexico, we acted on the anticipation of specific corporate events that should result in significantly improved vulnerability scores for the companies. The general country environment, and hence the country score for these companies, also looks more supportive right now.

- We also increased hard currency exposure in South Korea and local currency exposure in Poland. In terms of our investment process, this resulted in an improved correlation score for the country. In South Korea, the improved sovereign valuation also boosted the country's correlation score.

- We reduced local currency and hard currency quasi-sovereign exposure in Brazil and Argentina. We also reduced hard currency corporate exposure in Argentina and hard currency corporate exposure in Brazil. In terms of our investment process, this translates into the deteriorating policy/politics score for the country. In Argentina, the depreciation pressure on the currency is increasing which translates into the lower vulnerability score for the country.

- We also reduced local currency exposure in Russia and South Africa. In both countries, there is a growing disconnect between the currencies' valuations and the underlying commodity prices. This led us to lower our correlation scores for both countries.

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## Fund Performance

The VanEck Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) gained 0.47% in May, compared to 1.42% 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, South Africa and Ukraine. The Fund's losers included Brazil, Argentina and Indonesia. Turning to the market's performance, the GBI-EM's biggest winners were Czech Republic, Hungary and Poland. The biggest losers were Argentina, Brazil and Chile. The EMBI's biggest winners were Cameron, Mozambique and Ghana. The biggest losers were Belize, Tunisia and Brazil.

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

| | 1 Mo† | 3 Mo† | YTD | 1 Yr | 3 Yr | Life |
|---|---|---|---|---|---|---|
| Class A: NAV (Inception 7/9/12) | 0.47 | 1.60 | 6.47 | 7.74 | -3.05 | 1.03 |
| Class A: Maximum 5.75% Load | -5.32 | -4.25 | 0.39 | 1.52 | -4.94 | -0.18 |
| 50 GBI-EM GD / 50% EMBI GD | 1.42 | 4.15 | 8.09 | 11.00 | 1.46 | – |

**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



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.**