

# EM Debt Is Not A Monolith

By Eric Fine, Portfolio Manager

## VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBXCX / EMBUX / EMBYX

### Market Review

It seems to be a popular meme that emerging markets ("EM") debt is doomed in an environment of rising interest rates, especially following comments from Carmen Reinhart reported by Bloomberg<sup>1</sup>. EM debt is being slammed thematically, leading to a decline in both indices – the J.P. Morgan GBI-EM Global Diversified (GBI-EM GD) in local currency and the J.P. Morgan EMBI Global Diversified in hard currency. Our view is that, most broadly, the emerging markets debt asset class is not a monolith. There are many vulnerable countries outside emerging markets, and much depends on how countries react to the changed environment. The current environment is, in fact, a good example of how a blend fund (which can invest in U.S. dollar bonds or local currency bonds), and an unconstrained approach (which is not index-hugging) provide investors with the ability to maintain exposure to EM bonds without the correlation and beta of index components that favor large indebtedness.

Many countries, not just EM, are made vulnerable by rising interest rates and/or a rising U.S. dollar ("USD"). The issue is how countries react to this challenge. Italy, for example, has seen its bond market swoon as a result of market-unfriendly policy emanating from its new government. This is currently the world's fifth largest bond market. Europe, in general, is facing growth headwinds that could highlight other policy deficiencies and lead the market to test many of its bond markets. In our opinion, rising interest rates are testing all countries. Some will respond with good policy, and others will not.

Likewise, EM debt is not a monolith. If one can only look at EM debt as a monolith, and cannot choose to avoid vulnerable EM countries and move to strong EM countries, then there is a case for being negative on EM debt. Big "chunks" of the indices

(again, if EM debt only means indices to you) are vulnerable. Below are some of the big vulnerable chunks in local currency, and if you can't avoid them because EM debt is a monolith and you are worried about a stronger USD, then perhaps you have no choice but to be negative on EM debt. We, of course, have the ability to accommodate these problems:

- Turkey (6% of GBI-EM GD) stands out as the most vulnerable. It has large external financing costs, rising inflation, a weakening currency, low reserves, and no real plan to reduce fiscal expenditures. The banks need external financing and that is now especially challenging. We have been harping on Turkey for a year, as you know.
- Brazil (10% of GBI-EM GD) has a large fiscal deficit (around 7% of GDP) and the current election year is likely to see a presidential contest between leftist and rightist extremes that the market will likely be uncomfortable with.
- Russia (5% of GBI-EM GD) has absolutely fantastic fundamentals, but sanctions risks out of the U.S. seem to be on autopilot and, in our opinion, make the bond market un-investable.
- Central and Eastern Europe (Hungary is 5% of GBIEMGD, the Czech Republic and Romania are 4% and 3% respectively) have low yields, so any rise in yields is unlikely to be compensated for by carry. You are dependent on foreign currency (FX) appreciation here. And, with a slowing economy and risk of a rising USD, that case is harder to make.

- Similarly with Asia (we are thinking especially of Thailand (8% of GBI-EM GD) and Malaysia (6% of GBI-EM GD), the carry is so low the investment thesis must involve some expectation of FX appreciation, which is harder given concerns over the global growth cycle, USD, and interest rates.
- Mexico's (10% of GBI-EM GD) decades-old policy orthodoxy is being challenged by the likely winner of this year's presidential elections, and the market has not fully discounted the possibility that the president wins strong legislative support that could activate more radical policy.
- The above constitute well over a half of "local markets". Remember that bond indices favor large indebtedness, which is precisely what is being tested by the current cycle. It seems to us that at this stage in the cycle one is supposed to avoid correlation and beta, not seek it out.

The market is rightly testing EM economies through the lens of higher interest rates and upward pressure on the USD. Global financial conditions are changing, so it is right to see if current policies need adjustments for this new reality. Any country with a financing requirement (domestic, or external, fiscal, or balance of payments) will be beaten up and tested in some way or another. That is totally normal. Some countries will pass this test, others will not. Passing is not a theoretical exercise, as it will have to involve addressing the need for financing, so a "good" reaction involves borrowing less and/or growing less (so import demand decreases). There will be winners who react positively, and losers who do not. If one can position towards winners and away from losers, this will be a rich environment, but if one can only be over- or under-weight EM debt, it will look bearish in our view.

We should reiterate that the "case" for EM debt over developed market ("DM") debt is still basically intact. EM fundamentals are better than DM fundamentals, as displayed in our radar charts. (Please contact us if you want to see these charts; publishing rules prevent us from displaying them in our monthlies). Also, EM bonds pay higher spreads than DM bonds, adjusted for fundamentals. This is a reminder that all countries will be tested by the currently more difficult financing environment, and focusing only on EM as vulnerable is not appropriate. And DM bond markets have many vulnerabilities.

And another positive note is that USD credit has gotten cheaper, in our opinion. We have been looking, and will continue to look, to this sector to increase exposure. Local currency had outperformed much of this year, and USD credit had done poorly, but now local has caught up (or down, more accurately). We see USD debt as attractive now, as

long as duration is low, it is high spread, idiosyncratic, and ideally with catalysts.

There is a range of other countries that are part of EM debt that do not fit the negative tone towards the asset class. China is an emerging market, last time we checked, even though it is not yet part of the popular EM bond indices. Its currency has been relatively stable. Policy has been excellent across the board, in our opinion. The country's leverage is high, but it is domestic leverage. While still a risk, it is at risk of local capital flight, not of international capital flight. Locals trust and respect their government and its policies, and the government has imposed costs on capital flight that have kept it from becoming a crisis.

A number of countries are reacting to the new global financial reality by adjusting policy in powerful ways, either reducing borrowing or reducing borrowing and replacing the market with a lender of last resort like the IMF. These countries all have: a) lower duration bonds, so you do not need to take significant spread duration risk (and therefore correlation and beta) to express a view; and b) ongoing catalysts/proof of adjusting policy to the current new reality.

- Argentina is the poster-child. Rates have been hiked to 40%, fiscal deficits have been slashed, and the IMF looks likely to replace the market as a key financing source for a few years.
- Angola is moving towards an IMF agreement, too, and has likewise slashed fiscal deficits.
- Ecuador has replaced its finance minister and is launching a new wave of structural reforms.
- Mongolia is sticking with its IMF program.
- Whatever you think of Venezuela, it is not correlated with "the market".
- There are some boringly safe countries too, such as Belarus and Armenia, which play the U.S. against Russia in terms of financing. Poland is defensive simply by virtue of ongoing great policy and low financing requirements. Colombia, Chile, and Peru arguably fall into this camp, too.

In the past two months we reduced our local currency exposure. Net of FX hedges, we have about 30% in local currency and the rest in hard currency. Our local currency is Poland (10%), Argentina, Uruguay, Colombia, and Dominican Republic (just under 5% each).

1. Note that we simply do not have exposures where we see significant vulnerability, even if (especially if?) they make up large portions of “EM bonds”. We have no Turkey longs, no Mexico, no Brazilian real exposure (we are long bonds, but hedged FX), no Russia, no Thailand, no Philippines, no Hungary, etc.
2. Our local exposures add up to 30%, but almost all of the FX exposure is hedged. They include Argentina (FX hedged), Brazil (FX hedged), South Africa (FX hedged), and Colombia. We also have exposure to Poland.
3. We have around 70% in hard currency. This is more diversified, and includes the names noted in point 2.
4. The overall portfolio is generating a carry of over 7% with a duration of just under 4.

#### Exposure Types and Significant Changes

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

- We increased hard currency quasi-sovereign exposure in South Korea. Historical experience shows that South Korea’s debt tends to outperform in the environment of rising global rates. In terms of our investment process, this translates into the improved correlation score for the country.
- We increased hard currency sovereign and quasi-sovereign exposures in Ecuador. The country’s policy/politics score improved markedly following the appointment of the new minister of finance who is more market-friendly than her predecessor. The appointment should speed up the approval of the new economic plan and other structural initiatives.
- We also increased hard currency sovereign exposure in Angola, Mongolia, and Ghana. In Angola, the IMF concluded its Article IV consultation and the Board agreed with the staff assessment. Even though there is no news on the new program, the development shows that the government’s commitment to structural reform remains unchanged. Ghana’s macro/policy story remains strong – the IMF support continues to play an important role (as it does in Mongolia). These considerations were important for us when we looked at the improved valuations (following an earlier selloff) and new bond issues. In terms of our investment process, this translated into better vulnerability scores for these countries.
- We reduced local exposure in Uruguay. The country’s unique macro exposure to Argentina and Brazil has negatively affected the correlation score for the country.
- We also reduced local currency exposure in Mexico, including the supra-national bonds denominated in the Mexican peso. We are getting increasingly concerned about the risks associated with the presidential election’s outcome – the reversibility of reforms is one particular concern that stands out. In terms of our investment process, this worsens the country’s policy/politics score.
- We also reduced local currency exposure in Brazil and Singapore. Singapore is a well-run economy, but its bonds correlate strongly with U.S. Treasuries – hence a negative turn in the correlations score for the country. In Brazil, the politics/policy score took a major hit following the government’s disjointed attempts to deal with the truck drivers’ strike. The central bank’s inconsistent guidance acted in the same direction. The vulnerability score for the country also looks worse as the protracted truck drivers’ strike will likely have a meaningful impact on Brazil’s inflation, growth, and fiscal performance.

## Fund Performance

The VanEck Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) lost 3.93% in April compared to a loss of 2.96% 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.

Malaysia and Thailand. The biggest losers were Argentina, Turkey and Brazil. The EMBI's biggest winners were Oman, Iraq and Ecuador. The biggest losers were Zambia, Lebanon and Argentina.

The Fund's biggest winners were Angola, Ecuador and Egypt. The Fund's losers included Argentina, Uruguay, and Brazil. Turning to the market's performance, the GBI-EM's biggest winners were Colombia,

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

	1 Mo <sup>†</sup>	3 Mo <sup>†</sup>	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	-3.93	-4.25	-3.37	1.36	-0.88	1.09
Class A: Maximum 5.75% Load	-9.43	-9.79	-8.96	-4.50	-2.04	0.08
50 GBI-EM GD / 50% EMBI GD	-2.96	-4.48	-3.84	0.29	1.37	-

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

	1 Mo <sup>†</sup>	3 Mo <sup>†</sup>	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	1.72	2.66	2.66	8.77	-0.18	2.19
Class A: Maximum 5.75% Load	-4.17	-3.28	-3.28	2.51	-1.36	1.15
50 GBI-EM GD / 50% EMBI GD	0.66	1.33	1.33	8.61	2.04	-

<sup>†</sup>Bloomberg: Harvard's Reinhart Says Emerging Markets Are in Tougher Spot Than During '08 Crisis, May 16, 2018, <https://www.bloomberg.com/news/articles/2018-05-16/harvard-s-reinhart-says-emerging-markets-worse-than-08-crisis>

<sup>†</sup>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 1.71%; Net 1.26%. Expenses are capped contractually until 05/01/19 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. 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](http://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. 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.

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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](http://vaneck.com) for performance information current to the most recent month end and for a free prospectus and summary prospectus.**



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