

Manager Commentary

Emerging Market Fundamentals Still Working

By: Eric Fine, Portfolio Manager

Executive Summary

- In our view, emerging market (EM) fundamentals continue to “work,” and emerging market debt remains acquitted as an asset class
- We believe value is in emerging market, not developed market, debt
- However there are risks and problems

Overview

Our basic stance remains the same as last month: EM debt as an asset class has acquitted itself. This follows the summer sell-off triggered by taper talk, a rising U.S. dollar, and many large institutions calling rising U.S. rates a death-knell for the asset class. Our more specific view is that many EM countries have high real interest rates relative to their fundamentals and a few EM countries have high hard-currency credit spreads relative to their fundamentals. Some EM countries have neither. We currently own the former and not the latter. Much of what we write below is identical to what we wrote last month.

If you recall, our thesis at the height of the panic exit from EM debt two months ago was that the “fundamentals” were basically fine – debts were low, financial systems were healthy – so a reasonable policy reaction in our view was to allow currency weakness and hike interest rates. We believed that both of these moves, as part of monetary policy, would be sufficient to reduce the current account deficits that seemed to be the focus of market concern. The markets that grabbed the most attention – India, Indonesia, and Brazil – all saw their monetary policy makers implement some combination of tighter liquidity and higher interest rates. In each case, currencies stabilized and then rallied. Even countries that really do have deeper problems that may continue to remain unaddressed, like India, saw stability, and then strength. (More on India later: as a hint of what may be to come, we think the correct policy response needs to be tighter fiscal policy, which is extremely tough, and, thus, unlikely.)

Could it be more obvious that the Fed is in a trap? We had also argued previously that there was only one thing to say about the Fed’s taper: the Fed will taper if it can, and if it can’t it won’t. Our point was, and continues to be, that Fed tightening is constrained: if tapering bites, the Fed will back away. It did bite and the Fed backed away completely. The bottom line is that the Fed is neither going to kill growth, nor bankrupt the U.S. government. Now, if that game is played over a few times and the Fed loses credibility (or, loses more credibility), we believe that would be a key tailwind to EM debt.

If central bank balance sheet expansion (“money printing” to some) is the primary reaction of developed economies, and, in the emerging markets, central bank balance sheets are not expanding as much as those of developed markets, this means that a lot is being printed of one thing and less of another. Which price do you think will be under upward pressure? Our primary worry remains that U.S. policy makers will awaken and implement radical structural reforms and focus the central bank on inflation and eliminating moral hazard in the banking system. However, the risk that they will actually do this seems trivial to us.

In our view, value is in EM debt rather than developed market (DM) debt. Generally, EM bonds currently pay higher real rates than DM bonds, and especially so when fundamentals are taken into account. In our opinion, other central banks see this, which is, for example, why we think the Chinese central bank has reduced U.S. Treasuries as a percent of their total reserves over the last decade. These same Asian central banks are also offering swap lines to central banks such as Indonesia’s. They want to face strong counterparties.

There are risks and problems within emerging markets. EM inflation might be rising in some countries. Some big-name countries, like India, or, increasingly, Brazil (more on it later) are facing downgrades. We remain worried about India, South Africa, Turkey, and Malaysia, for the same reasons as before. A dollar rally spurred by U.S. growth would hit EM foreign exchange. Treasury sell-offs would do the same. Our response, though, is the same: own countries that are believed to be strong enough to weather this, and position defensively (and always in liquid instruments) when risks appear high/returns less attractive. In our opinion, this is not the case right now.

To emphasize, we remain very averse to any exposure in India (where we would not be surprised by some type of economic or financial crisis in the coming year), South Africa and Turkey, in local currency, and Venezuela and Ukraine, in hard-currency. In India, South Africa, and Turkey, real yields and reserves are currently low. India has the additional problem of deep fiscal issues that, we believe, are unlikely to be addressed before next year’s elections, or ever...barring a crisis that forces the issue, or inflation that covers up the issue.

In Venezuela, we see little chance of positive reforms before municipal elections in December. In our opinion, any pre-election mini-reforms are likely to accelerate inflation expectations and weaken the black-market exchange rate.

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.

Note that the domestic institutions that are set up to provide U.S. dollar liquidity to a U.S. dollar-starved economy are capitalized by... (roll of drums)... hard-currency bonds! The exact ones we would own if we still liked Venezuela. They can be sold by those institutions. In addition, we believe that market participants have been conditioned simply to sit on their Venezuelan bonds because of the high coupons and the historical fact that they have not defaulted in the past decade. We believe this has created complacency. In Ukraine, we see a very high degree of “un-analyzability”. One day, official statements make the country appear headed to a trade agreement with Europe and even an IMF program. The next day, official statements point in the other direction. In our experience, the right stance is to wait until everything is signed and done, and only then begin considering investing. South Africa and Turkey represent large slices of local-currency bond indices, and Venezuela is a large slice of hard-currency bond indices.

Exposure Types and Significant Changes

We have basically made no important changes to our portfolio. Our top five positions currently are: Indonesia, Mexico, Argentina, Philippines, and Colombia. Our top five positions last month were identical.

Biggest Country- and Bond-Level Changes

- We closed Greece, in hard-currency, from 2% to 0%, continuing our profit-taking of last month. Our price target was hit, while, in our estimation, politics have gotten a little hairier.
- We increased our Sri Lanka local-currency exposure to 4.5% from 1%. Here, we like the high current real yields and strong fundamentals. We also note that Sri Lanka was largely unaffected by the summer’s crisis in India.

Price, Interest and Currency (“FX”) Components of Fund Returns by Country for October 2013



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

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

Fund Performance

For October, the Fund returned 3.45%, compared to 2.75% in the local-currency index (GBI-EM Index), and 2.77% in the hard-currency index (EMBI Index). The Fund’s biggest winners in October were Argentina (hard), Indonesia (hard and local), and Portugal (hard). The Fund basically had no significant losing positions.

The market’s best performers during the past month were Argentina, Indonesia, and Belarus in hard currency, and Nigeria, Indonesia, and Malaysia in local currency. The markets’ worst performers of the past month were Bulgaria, Jamaica, and Lithuania in hard-currency, and Chile, China, and Thailand in local-currency.

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

	1 Mo*	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	3.45	-3.28	0.52	5.60
Class A: Maximum 5.75% load	-2.48	-8.83	-5.24	0.96
GBI-EM Index	2.75	-5.02	-1.60	--
EMBI Index	2.77	-4.09	-2.27	--

Average Annual Total Returns (%) as of September 30, 2013

	1 Mo*	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	3.41	-6.51	-0.80	3.11
Class A: Maximum 5.75% load	-2.57	-11.86	-6.48	-1.73
GBI-EM Index	4.40	-7.56	-3.74	--
EMBI Index	2.61	-6.67	-4.06	--

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 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.

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Mutual Funds



Data Source: Van Eck Research, Factset. All portfolio weightings and statements herein as of October 31, 2013.

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.

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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.

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. An investor 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.

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