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U.S. Elections Trump Global Bond Markets

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VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

The election of Republican Donald Trump has accelerated some of the trends we were anticipating. Since his election, we have seen a rout in bond markets globally amid expectations of higher inflation and fiscal spending, while equity markets have rallied on the prospect of an improved growth outlook. Perhaps what has been impacted most during this period has been emerging markets currencies, due to concerns about Mr. Trump's potential trade policies. Here are some considerations for emerging markets debt investors going forward.

First, President-elect Trump has promised to name China a currency manipulator. China's currency has just appreciated against the emerging markets currencies in its basket, creating additional devaluation pressure. In our view, further moves in this direction would be very negative for emerging markets currencies, as China is a crucial marginal buyer of commodities. China also faces outflow pressures which could strengthen in the event of further currency weakness or a policy challenge from the U.S. Second, upcoming European risk events, such as the Italian referendum and the Dutch and French elections, can now be viewed through the lens of Brexit and Trump's victory. We view Europe as fragile and, thus, vulnerable. Political pressure could create volatility and if it triggers something systemic, would represent another bid for the U.S. dollar. Third, inflation expectations have risen. Whether we end up with stag- or re-flation will take time to ascertain, but either way, the consensus view of low rates forever is being fundamentally challenged. It is not extreme to wonder whether "good" news (reflation) hits risk-free duration, and "bad" news (stagflation) hits credit duration.

After the election, emerging markets currencies have already moved down significantly. The question is: Has most of the move already happened? On a fundamental basis, that is where the prefix re- or stag- will matter. If it is reflation, commodities would be one source of eventual technical support, so maybe emerging markets currencies could do well. If it is stagflation, then emerging markets currencies do not get this support. In both scenarios, though, duration sells off.

Our basic stance pre-election remains – asset price outcomes are asymmetric. The magnitude of a downside not only seems much larger to us than the upside, but also more likely. Our estimates suggest that, in a range of adverse outcomes, the downside to emerging markets local and hard currency debt is multiples of the upside in the event of positive scenarios. Our key goal remains to have a portfolio that outperforms the adverse outcomes.

There are many reasons that have led to our conclusions. First, a U.S. Federal Reserve (the "Fed") that has realtively no room to cut rates in the event of an economic downturn. Second, rising inflation (whether it is stag- or re-flation remains to be seen) should be very negative for duration and bullish for the U.S. dollar. Third, emerging markets flows have seemed to us to be a "chase", leading yields in both local and hard currencies to tighten despite a general deterioration in emerging markets' ratings. Fourth, Europe appears broken, and upcoming events, such as the Italian referendum, Austrian elections, Dutch elections, and French elections, could be further "Brexit" moments. Fifth, although China's leverage has been mostly domestic, it is still leverage; it

is conceivable that this can be worked out slowly over time, but much less conceivable in an environment of rising U.S. yields, a stronger U.S. dollar, and weak emerging markets currencies that are boosting the Chinese currency against its basket.

As regards the Fed's ability to ease using traditional policy tools in the case of an economic downturn, the average easing cycle historically has been approximately 700 basis points (bps) – one or two more 25 bps hikes (provided the Fed is not paralyzed by indecision in December) will not bring us even close to the levels required to make a meaningful downward interest rate adjustment if economic activity turns south. This is likely a scenario to pay attention to a few quarters from now (for the adverse reason that inflation pressures are rising), but, in our opinion, the context of a monetary authority with no spare tire is a key market fragility.

Rising inflation pressures may be the bigger near-term challenge, pressuring yields and the U.S. dollar upward. Recently, there have been several changes in the previously placid inflation landscape in the U.S. and some other developed markets, as reflected (among other things) by rising market-based inflation expectations. While the increase had been gradual in the U.S. and the Eurozone, inflation expectations in the U.K. skyrocketed on the back of the post-Brexit weakness in sterling. The Bank of England took notice, raising its own inflation forecasts up in the last quarterly report. An important development is that the energy component can become a net positive contributor to headline Consumer Price Index (CPI) inflation in the U.S. in December 2016, possibly adding as much as 0.5% year-on-year to the headline print. This contribution might increase to 0.8% year-on-year or so in January-February 2017, possibly staying above 0.4% year-on-year in March. Finally, any hint of the post-election fiscal expansion in the U.S. steepens the nominal curve (just as it has done in the past), as markets will start pricing in stronger domestic activity and an increase in U.S. Treasury supply. It remains to be seen whether the latter scenario – reflation – will indeed materialize, and how fast. The probability attached to the stagflation scenario is clearly non-zero, given the number of the U.S. macro indicators signaling that the economy is already in the late stage of the cycle and uncertainty about the scope of the actual impact of any fiscal stimulus. Both scenarios, however, would be negative for duration and positive for the U.S. dollar (albeit to a varying degree).

Past experience shows that emerging markets spreads have often declined when U.S. rates have risen, presumably, as a response to expected increases in final demand. However, this time around we are facing a few important complications – deteriorating sovereign ratings (the average rating in the J.P. Morgan Emerging Markets Bond Index Global Diversified is now sub-investment grade), record shorts in the U.S. dollar via U.S. dollar-debt issuance in emerging markets, a U.S. economy that may be in the late stages of its recovery, and rising protectionism. It appears that the recent inflows into emerging markets debt have ignored those facts and led to emerging markets spreads tightening excessively when compared to ratings. This strikes us as a "chase" for yield unwarranted by fundamentals and risk scenarios.

Despite the recent improvement in the quality of Europe's macro flow, per the recent Citibank Eurozone Economic Surprise Index (which measures how data releases have generally compared to economists' prior expectations), the region's fundamental problems remain unresolved. We are concerned about the on-going accumulation of TARGET2 imbalances (Eurozone's real-time intrabank gross settlement and payment system) which not only show the highest interbank flows since 2008, caused by quantitative easing, but also a large confidence gap between banks in Germany and the Netherlands and their counterparts in Italy and Spain. We also remain concerned about a lack of certainty on Deutsche Bank as senior credit default swaps have remained firmly stuck above 200 bps and potential spillovers to the banking sectors in other European countries, as well as a higher likelihood of unexpected outcomes in the upcoming Italian referendum (December 2016) and the Dutch and French elections in 2017.

China's leverage story refuses to go away and the policy reversal earlier this year towards more credit expansion (and less reform) as growth started to falter is noteworthy. There is an argument that China's debt pile can be dealt with in a gradual way. Our concern is that higher interest rates in the U.S. will cause a global chain reaction that will increase the debt service burden in the foreseeable future, reducing the amount of resources available for other purposes (consumption and investment), and increasing the risk of a negative feedback loop (i.e., higher leverage with even lower growth). A prospect of a stronger U.S. dollar as U.S. rates go up will increase the depreciation pressure on the renminbi – especially against the backdrop of steady money supply growth in China and deteriorating competitiveness against other regional currencies. China's deteriorating international reserves ratios (reserves/M2 [includes cash and all highly liquid assets], reserves/GDP) might become an issue once again.

We realize it is unusual for fund managers to be bearish/cautious about their own asset class, and while this is perhaps difficult to explain in a typical sales presentation, we have resisted joining the party and chasing yield. This has clearly hurt us in retrospect, but October was a welcome, but premature, confirmation which has

underlined our view. We expect more of the same and are, therefore, not changing our basic portfolio stance of low duration and low/no emerging markets currencies. The only possible changes we are considering now are a reduction of Ukraine exposure and increase in Russian exposure given the recent Trump victory in the U.S. presidential election. Down the road, we are also open to Brazilian local currency, but it could take some time before our concerns either abate or manifest.

Getting into more detail, our sovereign and quasi-sovereign hard currency exposure accounts for about 70% of our portfolio. Our key exposures include South Korea, Brazil, and Argentina. South Korea is a net sovereign creditor (i.e., it has more U.S. dollar reserves than U.S. dollar liabilities) and its bonds have proven to outperform in risk-off environments. Brazil is also a net sovereign creditor and the government appears to be making faster than expected progress on structural issues (approving the fiscal reform legislation). Our exposure in Brazil also include Petrobras bonds – the company has reduced debt coming due over the next few years and accelerated its plans to reduce leverage.

We also own selected U.S. dollar-denominated corporate bonds in Mexico, Russia, Peru, and Argentina. In Mexico, we focus on defensive diversifier names that are mainly linked to the inelastic components of domestic demand. In Russia, the public and the corporate sectors are de-levering and paying down debt with barely any new debt issued due to sanctions– which keeps technicals strong. The country is a net creditor and economic policy-making is excellent, both on the ministry of finance and the central bank sides. In Argentina, the new government has opened the country to new financing, benefiting solid corporate credits. Some corporates have good payment records, never defaulting even when the government did. In Peru, companies like Lima Metro are likely to be the main beneficiaries of the post-Peruvian election shift in economic and investment policy.

Finally, we have sovereign exposure in countries which either aim for an International Monetary Fund (IMF) program (Mongolia, Egypt) or already have it (Ukraine).

Exposure Types and Significant Changes

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

- We added hard currency sovereign exposure in South Korea. The country's hard currency debt tends to outperform in a risk-off environment. In terms of our investment process, this translates into the improved correlation score.

- We also increased quasi-sovereign hard currency exposure in Argentina and Peru. We consider quasi-sovereign exposure a more attractive play on improving idiosyncratic sovereign fundamentals. In terms of our investment process, this translates into improved correlation scores.

- We also added sovereign hard currency exposure in Jordan and Pakistan – in the latter, stronger fiscal and external buffers (resulting in a rating upgrade by S&P) improved the politics/policy score.

- We reduced quasi-sovereign hard currency exposure in Russia and South Africa. In South Africa, the escalation of the conflict between President Zuma and Minister of Finance Gordhan prompted us to revise down our policy/politics and vulnerability scores.

- We also reduced sovereign hard currency exposure in Zambia, Paraguay, and Trinidad and Tobago. The reduction in Paraguay and Trinidad and Tobago was due to our concerns about duration which led us to assign lower correlation scores for these countries. In Zambia, a lack of progress with the IMF resulted in lower politics/policy score.

Fund Performance

The Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) lost 0.04% in October, compared to a 1.04% loss 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 Ukraine, Brazil and Mexico. The Fund's biggest losers were Argentina, South Korea and Russia.

Turning to the market's performance, the GBI-EM's biggest winners were Brazil, Peru and South Africa. The biggest losers were Indonesia, Philippines and Turkey.

The EMBI's biggest winners were Pakistan, Ghana and Ecuador, while its biggest losers were Mozambique, Venezuela and the Dominican Republic.

Average Annual Total Returns (%) as of October 31, 2016

	1 Mo†	3 Mo†	YTD	1 Yr	3 Yr	Life
Class A: NAV (Inception 7/9/12)	-0.04	-0.33	7.56	5.55	-2.31	0.04
Class A: Maximum 5.75% Load	-5.76	-6.11	1.30	4.62	-3.00	-0.69
50 GBI-EM GD / 50% EMBI GD	-1.04	1.07	14.81	11.48	1.47	–

Average Annual Total Returns (%) as of September 30, 2016

	1 Mo†	3 Mo†	YTD	1 Yr	3 Yr	Life
Class A: NAV (Inception 7/9/12)	0.33	0.66	7.60	8.71	-1.18	0.05
Class A: Maximum 5.75% Load	-5.41	-5.09	1.35	2.43	-3.11	-1.34
50 GBI-EM GD / 50% EMBI GD	1.21	3.37	16.02	16.75	2.75	–

†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 1.44%; Net 1.25%. Expenses are capped contractually until 05/01/17 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 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 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). Index returns assume that dividends of the index constituents 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.

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.

Emerging Markets Hard Currency Bonds refers to bonds denominated in currencies that are generally widely accepted around the world (such as the U.S.-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.

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 50/50 benchmark (the "Index") is a blended index consisting of 50% J.P. Morgan Emerging Markets Bond Index (EMBI GD) Global Diversified and 50% J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM GD). The J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM GD) tracks local currency bonds issued by Emerging Markets governments. The index spans over 15 countries. J.P. Morgan Emerging Markets Bond Index (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. The J.P. Morgan Emerging Country Currency Index (EMCI) is a tradable benchmark for emerging markets currencies versus the U.S. Dollar (USD). The Index compromises 10 currencies: BRL, CLP, CNH, HUF, INR, MXN, RUB, SGD, TRY and ZAR. The Consumer Confidence Index (CCI) is an indicator designed to measure consumer confidence, which is defined as the degree of optimism on the state of the economy that consumers are expressing through their activities of savings and spending.

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 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. 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.