VanEck® FUNDS

Finding Diamonds in the Rough

By Eric Fine, Portfolio Manager

VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

Market Review

The basic elements of the adverse setup that we see for emerging markets (EM) remain. They are: economic divergence (i.e., rising U.S. interest rates, stronger relative U.S. growth rates, and upward pressure on the USD), "China", and that the most risky EM economies happen to be big index components. We've harped on these before, and wrote of further evidence for them in our recent piece summarizing the top takeaways from the recent annual IMF meetings in Indonesia (Top Takeaways from the 2018 Annual International Monetary Fund (IMF) Meetings).

We do have plenty of positive things to say about EM, but they are generally only positive for a portfolio like ours which seek to avoid big index components and gain meaningful exposure to idiosyncratic bonds. In other words, if EM to you means "China, Turkey, and Mexico" … Or if EM to you means "the U.S. dollar" … Or if EM to you means "global growth" … Or, finally, if EM to you means "global interest rates", then we are bearish through all those lenses. Put differently, if you cannot do much to protect yourself from the current environment (i.e., avoid bad names with big index slices, and/or gain meaningful exposure to idiosyncratic and cheap bonds, or control your duration and EM currencies), be bearish. The overall picture remains unattractive, in our opinion, for those with a top-down view of EM.

There are plenty of positive developments in EM, but market structure means that many investors will be unable to take advantage of the diamonds in the rough. If EM, contrary to the above paragraph, is just a term to capture a large number of issuers with varying degrees of exposure to current global economic drivers, there's plenty to be excited about. There are a number of countries that are reacting positively to global headwinds, for example. In fact, since we have been so "bearish" lately, let's honor these bullish "things" with their very own bullet points:

- Brazil economic policy transformation
- Argentina reacting to global challenges by deepening reform and replacing market funding with IMF funding
- Mongolia, Ukraine, and others, sticking with IMF programs
- Russian economic policy best in decades; Russia is uninvestable only due to U.S. sanctions policy
- Most of EM using currency flexibility as a shock absorber, reducing external imbalances
- The global fixed income nirvana of low duration and high carry in U.S. dollars can now be found in EM!
- USD bonds cheapening and with nobody there to buy them due to outflows and/or fear of EM
- U.S. growth juggernaut leading to copycat policy (e.g., European and other countries enacting tax and regulatory reform)

Back to the main thread of our story. Starting with a key risk to EM-economic divergence. Bearishness abounds, obviously, and we say "obviously" given global asset price behavior so far this year. We have argued from the beginning that the selloff in EM began in earnest in the second quarter of 2018, when global growth went from synchronous to divergent. We've been arguing since then that we see no change in sight. EM central banks were already getting more hawkish due to inflation pass-throughs from currency weakness. "China" re-asserted itself as a risk and global markets such as U.S. equities have been drawn into what was originally an EM-focused selloff. What we find most worrisome now, though, is that the great bullish argument for "the market" is that the U.S. economy is going to "stink." Yes, that's basically the argument. In our opinion, the U.S. is going to get dragged down by global economic weakness, its central bank will stop tightening monetary policy, and we will see lower interest rates and a crashing U.S. dollar as the country re-stimulates. We have many problems with this line of thinking. First, we see no evidence of a U.S. recession. Second, if there were a recession, we continue to see the U.S. dollar rallying … in our opinion, you get one chance to guarantee the global banking system, not two, and the second time you will see a capital flight to the U.S. Anyway, those are our views, but our strongest opinion is that we see almost no institution arguing that the U.S. growth path will continue, will diverge for a long period of time, boosting U.S. interest rates and the USD, while global growth falters … If this doesn't happen and the U.S. is instead in recession, the USD rallies even more. This means that we need to see only a small probability of our view priced by the market.

"China" has emerged as a new market risk, as headlined in our top takeaways from the annual IMF meetings. You can read our report, which gives you our language when it mattered (i.e., before it happened). Right now, we'd make the following simple points. First, tension between the U.S. and China has moved beyond simply "trade" and now includes direct investment and security. The tensions are broadening, in other words. We still see only gradual acceptance/pricing of this by markets. Second, the market will at some point have to acknowledge the logical tension in overall Chinese policy. A country that says it must de-lever (and gets praised by us for doing so) and which subsequently backs down each time, and ends up re-stimulating, must face credibility headwinds. We put it that way because we have heretofore seen Chinese policy credibility as high. And this is important to us, as all EM crises we've seen have had policymaker denial as a consistent feature. In our opinion, Chinese policy contradictions are coming into sharper focus at the same time that policymakers are losing credibility. Chinese policymakers also seem to be misreading the U.S. position, as argued in our IMF piece.

Mexico is now at risk of joining the ranks of EM countries facing idiosyncratic adversity and which happen to be important index components. We need to come up with a bumper-sticker phrase for this risk, but so far it sounds something like "the countries where we see idiosyncratic adverse risks also happen to be very important ones." In any year, there's always a list of countries about which we have special concern. In 2018, though, the list is made up of big index names. Turkey has been on our list all year. It remains there, despite apparent rapprochement with the U.S., due to heterodox policy (in English, they look set to start lying about inflation, which ends up worse than just bad inflation). Russia remains on our list, too (though in their case it is due to U.S. sanctions policy which makes their bond market uninvestable, because their economic policy is unimpeachable, in our opinion). Brazil was on our list, because their population was in the process of choosing new political leadership, and therefore there was no real answer to "whither policy?" Now there is, and it is very constructive, economically. (See Brazil: Binary, Bumpy, Buy? by Portfolio Manager Eric Fine.)

And now, Mexico? The same Mexico that has an A3 rating from Moody's, and BBB+s from the other major rating agencies? The same Mexico that has had, in our opinion, nothing but orthodox economic policy, an independent central bank, and excellent market communication for over two decades? Yes, that Mexico. A Mexico we have learned from, praised, and watch get upgraded over the years … while gross domestic product (GDP) and trust in government declined … and led to the election of its left-wing "populist." (This is a term we use only because it is common in the media, but which to us is problematic, as it seems to be applied to "popular ideas we disagree with, and are therefore stupid.") A Mexico to which we gave the benefit of the doubt following the recent election of President Andrés Manuel López Obrador (AMLO), by taking our Mexico position to neutral (relative to our benchmark). Why the change?

Basically, because the country's new president has sent a very negative signal in his handling of a proposed new airport near Mexico City. The details are available in the popular media. Our concern is both what was done and how it was done. What was done is that the president-elect has signaled that he wants to cancel the airport project. This hits some bottom lines because there are bonds associated with the airport (they are somewhat complex, and we looked at the bonds, and chose not to own them, thankfully), but that is not the import. How it was done is that a "consultation" with the population took place (not a "referendum") and the carefully-managed "consultation" gave the new president a result he felt he could use to cancel the project. At the end of the day, one airport is not going to have dramatic economic repercussions in and of itself. The concern, legitimate in our

opinion, is that all foreign investment will face similar risks under the new government. This break with expectations, we should emphasize, is coming after a two-year period during which the market debated whether Mexico was electing "good AMLO" or "bad AMLO." The market decided pretty overwhelmingly that Mexico elected a "good AMLO". Positioning is still near record longs in Mexican local bonds and currency. So, we are left thinking that the market has been caught off-guard in Mexico, once again. (The last major moments being the U.S. election of President Trump, which was unexpected, and the subsequent rapprochement in the form of a new trade deal, which was also not expected at the beginning of Trump's term).

The good things that are happening in EM map to our portfolio. We continue to have high USD/low EM local currency, low duration, high carry, and high idiosyncrasy. Seeing risks in EM does not translate into running for the hills. We have large exposure to Argentina and Brazil, as we believe they are idiosyncratic enough to buck the adverse trends we note. After those names, we are very diversified, with exposures ranging from Ukraine and Mongolia to South Korea and Belarus. These are obviously the result of our investment process in which we search for bonds that are cheap to their fundamentals, and pass tests (economic, policy/politics, and technical). The result is our portfolio, changes to which we describe below.

It might be interesting to point out that during most of the month of October, our fund was underperforming an initially strong EM debt market. Throughout October, though, we only saw confirmation of the fundamental views outlined above, and continued to stick with our portfolio of low duration, high USD, and high idiosyncrasy.

Exposure Types and Significant Changes

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

- We increased local currency exposure in Brazil. We were mostly motivated by the expected market-friendly outcome of the presidential election which should result not just in policy continuity but, hopefully, in more positive moves on the structural front (such as granting formal independence to the central bank). In terms of our investment process, this significantly improved the policy/politics score for Brazil.

- We also increased our hard currency sovereign exposure in Guatemala and El Salvador. The bond of our choice in Guatemala cheapened by nearly 4 standard deviations after August, significantly improving the technical score for the country where the macroeconomic backdrop remains largely benign. In El Salvador, recent deals in the legislative assembly lowered the government's liquidity/non-payment risks, improving the country's policy/politics score.

- We increased our quasi-sovereign hard currency exposure in Mongolia and South Korea. In Mongolia, we bought a new quasi-sovereign issue that was almost 100bps wide to the sovereign, improving the technical score, while we remain comfortable with the country's fundamentals. South Korea's sovereign and quasi-sovereign hard currency bonds remain our preferred "bunker" securities that perform extremely well during fixed income selloffs, which implies the strong technical score.

- We reduced local currency exposure in Mexico. The main reason was a higher probability that the national consultation would result in a cancellation of the Mexico City's new airport (this outcome has since materialized), with the ensuing negative implications for the sovereign rating and fiscal outlooks, and the future of the existing legal contracts. In terms of our investment process, this lowered the policy and economic scores for the country.

- We reduced hard currency sovereign exposure in Ukraine and Nigeria. In Nigeria, we continued to reduce the duration exposure, as, in our view, the correlation score for that part of the curve was deteriorating. In Ukraine, our key motivation was uncertainty about the IMF program for the country, and the government's inability to provide straightforward answers regarding meeting the program's targets. Even though the IMF subsequently signed a new deal with Ukraine, we felt that the level of uncertainty at that point justified a lower policy score for Ukraine.

- We also reduced hard currency corporate exposure in China and Zambia. In China, we grew more concerned over the local market's ability to provide refinancing to certain companies. We therefore removed from our portfolio the companies that had lower balance sheet liquidity. In Zambia, we have increasing concerns about the sovereign's solvency and ability to service its debts. This factor lowered the sovereign score for the corporate bond that we owned, resulting in the country's expulsion from the portfolio.

Fund Performance

The VanEck Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) lost 1.08% in October compared to a loss of a 2.06% 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 Brazil, Ukraine, and Colombia. The Fund's least contributors were Argentina, China, and Poland. Turning to the market's performance, the GBI-EM's biggest winners were Argentina, Brazil and Turkey. The biggest losers were Mexico, Colombia, and South Africa. The EMBI's biggest winners were Lebanon, Brazil, and Suriname. The biggest losers were Sri Lanka, Venezuela, and Senegal.

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

	1 Mo†	3 Mo†	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	-1.08	-2.69	-5.52	-6.11	-0.60	0.66
Class A: Maximum 5.75% Load	-6.78	-8.28	-10.99	-11.55	-1.78	-0.28
50 GBI-EM GD / 50% EMBI GD	-2.06	-3.95	-7.50	-5.41	0.89	–

Average Annual Total Returns (%) as of September 30, 2018

	1 Mo†	3 Mo†	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	1.51	1.66	-4.49	-4.72	0.29	0.84
Class A: Maximum 5.75% Load	-4.39	-4.19	-10.02	-10.21	-0.89	-0.11
50 GBI-EM GD / 50% EMBI GD	2.05	0.25	-5.55	-4.60	1.86	–

†Monthly returns are not annualized.

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 acquired fund fees and expenses, interest expense, trading expenses, dividends and interest payments on securities sold short, taxes and extraordinary expenses. 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 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.

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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.

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