VanEck™

VanEck FUNDS

Economic Risks in Developed Markets Impact Emerging Markets Debt

By Eric Fine, Portfolio Manager

VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

The developments of the past few weeks provide additional evidence that the main postulates of the market framework we've used this year – real and numerous headwinds/risks that are set against the tailwind of easy central banking policies – remain in place. It also became more obvious that the headwinds are strengthening, while the tailwind of lower interest rates is fading. The most notable sentiment shift is that markets started to doubt that the accommodative monetary policies in advanced economies will last forever. Further, it looks like these doubts are not just figments of imagination – monetary authorities' communications are also changing with both the European Central Bank (ECB) and the Bank of Japan (BoJ) refusing to automatically extend and deepen their respective quantitative easings (QE) despite a lack of improvements in the growth/inflation outlooks. Instead, we see attempts (however questionable) to introduce changes within the existing policy framework (BoJ) as well as more emphasis on the goverments' "fair share" (fiscal stimulus and structural changes).

On this side of the pond, the Federal Open Market Committee (FOMC) looks increasingly split with hawks finally coming out of hibernation (three openly hawkish dissenters at the September meeting) but with doves also gaining more confidence (three FOMC members – according to the latest "dot" plot - now expecting that the policy rate will remain unchanged in 2016). The upside correction in term premia is a clear manifestation of the changing market narrative – and this is the area where the proverbial sky is the limit (if markets become more concerned). Given the deteriorating situation in Europe's banking sector, the stronger headwinds are likely to result in additional USD strength (at least for now) – with obvious implications for emerging market (EM) FX and local currency debt.

In the past month, we received more signals that the U.S. economy is entering the late stage of recovery (despite the fact that there were some upside surprises) while at the same time there's been some sporadic improvement in market- and survey-based inflation expectations. This raises the question, what would the Federal Reserve (the"Fed") do in December if this stagflation-like scenario becomes more entrenched? The problem is that the Fed (and markets) currently assume very limited rate hikes (about one and a half full hikes in one year and just under three full hikes in the next three years) which may be very optimistic. Further, this scenario would also imply more expensive debt roll over for EM corporates and sovereigns (who levered up during the QE era), smaller net capital inflows to EM, and growth disappointments with obvious implications for many EM assets. Finally, the level of political noise in the Eurozone will likely remain elevated with the upcoming Italian referendum scheduled for early December and the French presidential elections next year (April/May).

In terms of our investment process, these risks translate into more countries failing the correlation tests as: (a) further U.S. treasury sell-offs will likely drag low nominal EM yields higher with them; or (b) economic weakness in developed markets (DM) will result in higher credit spreads leading to inevitable spillover effects in EM. As a result, in the past month we finalized the portfolio's adjustment towards high-quality/idiosyncratic dollar-denominated debt and away from local-currency debt. We also continued to reduce the portfolio's duration.

Getting into more detail, we currently have no local currency exposure, which meant closing positions in local currency markets in Brazil, Indonesia, and Colombia, even though all of these

countries have high real and nominal interest rates, declining inflation and inflation expectations, and established reform programs.

In hard currency, we increased investments in the names we had before and added several new names where we see powerful idiosyncratic drivers. Our sovereign and quasi-sovereign exposure now accounts for about 65% of our portfolio, with corporate debt accounting for the rest. Our key exposures include Brazil (including Petrobras bonds) where the new government is improving policy significantly (fiscal reform is especially noteworthy). The country is still a sovereign net creditor (i.e. it has more dollar reserves than dollar liabilities), while Petrobras has reduced debt coming due over next few years and has accelerated its plans to reduce leverage. We also own USD-denominated corporate bonds in Mexico. These are defensive diversifier names that are mainly linked to the inelastic components of domestic demand with limited exposure to the U.S. investment cycle.

Our positions include several corporate names in Russia (both private and quasi-sovereign). Similar to Brazil, Russia retained its sovereign net creditor status with the public and the corporate sectors de-levering and paying down debt due to sanctions (with barely any new debt issued – which keeps technicals strong). The economic policy-making is excellent both on the ministry of finance side and the central bank sides. The only possible change in our view here would be another round of escalating sanctions from the U.S. We also like select Argentine and Peruvian corporates. As regards the former, 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. As regards our corporate exposure in Peru, companies like Lima Metro are trading with a wide spread to sovereign bonds, and should tighten as they are likely to be the main beneficiaries of the post-election shift in the economic and investment policy (the new government's focus on infrastructure development).

Even though we are cognizant about global headwinds, we are not completely averse to risk-taking and we have sovereign exposure in countries which either aim for an International Monetary Fund (IMF) program (Mongolia) or already have it (Ukraine). In Ukraine, the IMF program anchors economic policy, market confidence, and provides dollar financing while the U.S. support includes U.S.-guaranteed bond issuance. In Mongolia, the new government is 'cleaning house', admitting problems and moving to address them. Discussions with the IMF on a lending program now look more likely, which is not fully in the bond price (whereas the decline in the price of copper is somewhat priced in).

We also increased exposure to "bunker" bonds in Israel and South Korea. Both countries are net sovereign creditors with solid fiscal accounts and large external surpluses. These bonds are also proven to outperform in the risk-off environment.

Exposure Types and Significant Changes

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

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

- We also added sovereign and quasi-sovereign hard currency exposure in Turkey and Belarus. In the former, the rating downgrade to sub-investment grade (which was widely expected by market participants after the failed coup attempt) removed lingering uncertainty improving the country's vulnerability score. In the latter, talks about the IMF program (and, hopefully, the accompanying policy moves) should improve the policy/politics score.

- We also added quasi-sovereign hard currency exposure in Russia and sovereign hard currency exposure in Pakistan.

- We reduced local currency sovereign exposure in Brazil and Indonesia. In both countries, we are concerned about the deteriorating correlation tests (correlations with the Fed). In the case of Brazil, the central bank continues to reduce its FX swap book (even though it reduced the volume of daily transactions) and this can limit the extent of any potential real (BRL) appreciation going forward.

- We also reduced local currency sovereign exposure in Mexico and Colombia. In Mexico, the Banxico Governor frequent comments about the peso are not helpful in the context of the relatively low reserve adequacy, while the on-going uncertainty about the Fed's intentions has a strong impact on local markets given the strong ties with the U.S. economy. In terms of our investment process this results in weaker scores for correlation and policy/politics tests. In Colombia, the country's exposure to fluctuations in the price of oil was our main concern – especially in the light of potential increase in USD appreciation pressures. In terms of our investment process, this shows as a weaker correlation score.

- We also reduced quasi-sovereign and corporate hard currency exposure in Chile.

Fund Performance

The Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) gained 0.33% in September, compared to a 1.21% gain 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 Mongolia, Argentina, Indonesia, Colombia and Russia. The Fund's biggest losers were Mexico, Peru, Brazil, Ukraine, and Pakistan.

Turning to the market's performance, the GBI-EM's biggest winners were South Africa, Colombia, Russia, Brazil and Indonesia. The biggest losers were the Philippines, Mexico, Malaysia, Turkey, and Thailand. The EMBI's biggest winners were Venezuela, Mongolia, Ghana, Croatia, and South Africa, while its biggest losers were Mexico, Vietnam, Pakistan, Gabon, and the Philippines.

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	–

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

	1 Mo†	3 Mo†	YTD	1 Yr	3 Yr	Life
Class A: NAV (Inception 7/9/12)	1.99	2.63	6.90	-3.46	-0.69	-0.12
Class A: Maximum 5.75% Load	-3.90	-3.29	0.68	-9.05	-2.63	-1.59
50 GBI-EM GD / 50% EMBI GD	4.63	3.90	12.24	5.96	1.75	-

†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, 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. 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.