VanEck®

VanEck® FUNDS

# Time to Reduce Local Currency Exposure

By Eric Fine, Portfolio Manager

## VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

### Market Review

After over a year's exposure to local currency of greater than 50% and after several monthlies in which we telegraphed our desire to reduce some of this higher-beta risk, we are now doing so. We currently have approximately 40% of the Fund in local currency. This is fairly concentrated in Brazil, Russia, Argentina, Colombia, and other countries. The rest of the Fund is more diversified and characterized by bonds with short duration, high spread, and high idiosyncrasy. We really do not want to wake up in the morning thinking about Janet Yellen or Kim Jong Un. Overall, this leaves us with a portfolio that has a duration of approximately 3 and carry of around 8.4%.

We reduced this local-currency risk for a combination of bottom-up/country-specific reasons, together with some top-down/global macro reasons. To start with the top-down/global macro reasons – though we should warn you that we have been telegraphing these for a few months now. First, the risk of fiscal stimulus in the U.S. has clearly reemerged following the trio of hurricanes that have changed the political landscape. After only the first hurricane in Texas, President Trump was able to agree with Democrats on a postponement of the destabilizing and embarrassing government shutdown deadline. We warned of this risk in our last monthly and not only have U.S. Treasuries sold off since then, but the U.S. dollar has also begun to gain ground against some currency crosses.

Second, as we have been saying, we have had our eye on the exit because the Federal Reserve (Fed) does. So does the ECB European Central Bank (ECB). Both are looking to end their monetary experiments in the coming months/quarters. It seems blatantly inconsistent not only to believe that quantitative easing (QE) was effective (which is debatable in and of itself, but it did get asset prices higher), but also that its unwinding will not be a risky moment. We believe it will be a risky moment. The calculations are not super precise, but QE will be ending at a point when U.S., European, and Japanese government borrowing actually starts to rise, in aggregate, to approximately $1 Trillion per year. So it is not just an academic worry. Other concerns include the risk of 'trade war' type comments from the Trump administration, inflation in the U.S. (though there are no signs of this so far) that gets the rate path higher, and any shock to growth. Here, too, this could translate into tail risks on the bearish side, especially as market participants feel forced to buy risk because of ongoing central bank liquidity more than any other factor. Finally, since we are listing adverse risks, we might as well mention "Europe". The Eurozone's key problem of multiple fiscal policies and banking systems inside a single currency has basically not been addressed. Since the ECB now finds itself the owner of 40% of the zone's government debt, how is it going to hike rates significantly (and thus evidence its independence) when its own balance sheet is going to take the hit, perhaps requiring re-capitalization?

German elections are forcing Chancellor Merkel into an alliance with a party whose key planks are constraints on the European Stability Mechanism (an organization created in 2012 to safeguard and provide instant access to financial assistance programs for member states) that lent to crisis-prone members, among other policies. Prior to the election, we think the market generally predicted that Eurozone debt would be slowly, quietly, confusingly federalized, and that the same would happen to fiscal policies and financial sectors. That thinking seems wrong now, as the new coalition member is clearly opposed. In the meantime, the rise of the new populist/right wing party in Germany seems set to undermine longer-term confidence in the country as well

as the Eurozone. In addition, we have not even mentioned Catalan separatism, the key image of which seems to be Spanish national police perpetrating violence on peaceful grannies. We certainly would not write that if we had not seen similar descriptions in the popular media. But that is how the issue is being framed and, in our opinion, it seems like a loser for "Europe's" image. While we are not saying this is a crisis, we are saying that the market has moved Europe to the backburner, despite the absence of any complete solutions to its problems. Now those solutions look ever more unlikely. Those are the top-down reasons consistent with reduced local-currency risk.
What are the bottom-up/country-specific reasons? Most broadly, given the concerns above, we want to make sure that whatever local currency exposure we do have can outperform if those risks materialize and, in particular, which of the local-currency markets that remain in our portfolio despite these changes – Brazil, Russia, Argentina, and Colombia – are the significant ones. What Brazil, Russia, and Argentina have in common are high nominal and real interest rates, but also early-cycle economies that are undergoing structural reforms. They also have pretty good balance of payment fundamentals. (One could quibble about Argentina, but ending capital controls is boosting reserves on a secular basis, in our opinion, and mid-term elections are likely to strengthen the current reformist President Macri.)

This may appear as a strange way to answer a question: We reduced some local-currency positions, so here are the ones we did not reduce and why. For us, however, the point is that the ones that we have reduced do not meet those conditions. South Africa was reduced. Although it has high real and nominal interest rates, structural reform is not happening; it is not early in its economic cycle; and political risk seems binary and almost unanalyzable going into the 2019 presidential elections. Poland was another local-currency market we exited. In that country, real rates are OK, but nominal rates are very low, providing a very small cushion in the event that some of our top-down risks materialize. In other words, it is largely a currency trade and we mentioned above what we think about "Europe" – however much we respect the fundamentals in Poland. For what it is worth, the politics there are also messy. We also reduced Uruguay. This was much more of a profit-taking exercise. We loved the high real rates a half a year ago, and they rallied. We thought it would be included in the JP Morgan GBI-EM Index, and it was. So, we just do not love it anymore.

What does that leave us with? We still have around 35% of the Fund in local currency, dominated by Brazil, Russia, and Argentina, as described above. These are older, well-established positions for us. The remainder of the Fund is diversified and characterized by high-spread, short-duration bonds with a great deal of idiosyncrasy. As we have said, we do not like waking up thinking about Janet Yellen or Kim Jong Un, or oil prices. Who would? We think our portfolio largely fits that bill. Some of the larger allocations include Venezuela, Ukraine, El Salvador, Ecuador, and others. We have written about these in the past and we feel reconfirmed in our stance. Venezuela made important bond payments in September that supported bonds. Ukraine just passed pension reform, which was not completely expected and paves the way for a better IMF relationship. El Salvador's two main parties agreed on pension reform, also unexpected, which boosted bond prices. Ecuador has a new president who is proving to be more reformist than expected, and this has only begun to be appreciated by the market, in our opinion.

## Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions are currently: Argentina, Brazil, Russia, Venezuela, and Ukraine.

- We increased local sovereign and hard currency corporate exposure in Brazil. Despite the second round of corruption charges, President Temer looks less vulnerable now (the Batista brothers are back in jail, the prosecutor general is in office) and the government can now focus more on the reform process. In terms of our investment process, this improved the country's policy/politics score. We also increased local sovereign and hard currency quasi-sovereign exposure in Russia. The disinflation process appears well entrenched and inflation expectations are falling rapidly – leaving the Central Bank of Russia more room to ease (with caution, keeping the real rates high). In terms of our investment process, this improved the policy/politics score for the country. Our quasi-sovereign exposure in Russia is a short-tenor, high-rated, and very liquid bond which should benefit from the improved correlation score.

- We further increased hard currency sovereign exposure in Venezuela, as well as hard currency quasi-sovereign exposure in Israel, and hard currency corporate exposure in Indonesia. In Venezuela, even though the macroeconomic situation remains dire, the government appears to be in position to get more funding from Russia and China, reducing the near-term probability of default. In terms of our investment process, this improved the correlation score for the country. The reason for increasing our hard currency exposure in Israel were similar to Russia – we bought a high-quality short-dated quasi-sovereign bond that benefit from the improved correlation score. Our hard currency corporate addition in Indonesia was a new issue that looked cheap relative to the underlying fundamentals.

- We reduced local exposure in Poland and Uruguay. In Poland, new positive macro catalysts are not particularly obvious at this stage, whereas the prospects there of a definitive resolution of the spat with the EU are dim. This means that the headline risk is here to stay weighing on Poland's policy/politics score. In Uruguay, the valuations worsened further after the multi-week rally and our process told us to reduce exposure to the existing local bonds. Meanwhile, there do not seem to be new initiatives on the economic policy front that would support tighter valuations. In terms of our investment process, this worsens the policy/politics score for the country.

- We reduced local sovereign and hard currency corporate exposure in Peru. Our local exposure was a long-duration bond and we believe that such assets might be adversely affected by the worsening correlation score. We also reduced local sovereign and hard currency quasi-sovereign exposure in South Africa. We believe that the chances of the impending local rating downgrade are increasing (with the subsequent expulsion from the index) and that these are not fully priced in. In terms of our investment process, this worsens the vulnerability score for the country. Finally, we also reduced our hard currency sovereign exposure in Rwanda due to concerns about having longer duration in a situation when the correlation score is deteriorating.

## Fund Performance

The VanEck Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) gained 1.32% in September compared to a loss of 0.16% 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 Venezuela, Argentina, and Russia. The Fund's losers included South Africa, Indonesia and Poland. Turning to the market's performance, the GBI-EM's biggest winners were Russia, Argentina, and Colombia. The biggest losers were Turkey, South Africa and Poland. The EMBI's biggest winners were El Salvador, Belize, and Suriname. The biggest losers were Turkey, Kenya, and Nigeria.

**Average Annual Total Returns (%) as of September 30, 2017**

| | 1 Mo† | 3 Mo† | YTD | 1 Yr | 3 Yr | 5 Yr | Life |
|---|---|---|---|---|---|---|---|
| Class A: NAV (Inception 7/9/12) | 1.55 | 4.30 | 11.95 | 10.35 | -0.82 | 1.10 | 1.94 |
| Class A: Maximum 5.75% Load | -4.34 | -1.71 | 5.56 | 4.04 | -2.75 | -0.08 | 0.80 |
| 50 GBI-EM GD / 50% EMBI GD | -0.16 | 3.09 | 11.61 | 5.98 | 3.41 | 2.02 | – |

**Average Annual Total Returns (%) as of June 30, 2017**

| | 1 Mo† | 3 Mo† | YTD | 1 Yr | 3 Yr | Life |
|---|---|---|---|---|---|---|
| Class A: NAV (Inception 7/9/12) | 0.81 | 1.83 | 7.34 | 6.49 | -2.98 | 1.18 |
| Class A: Maximum 5.75% Load | -5.02 | -4.03 | 1.21 | 0.42 | -4.87 | -0.01 |
| 50 GBI-EM GD / 50% EMBI GD | 0.16 | 2.93 | 8.26 | 6.26 | 1.28 | – |

†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 1.68%; Net 1.25%. Expenses are capped contractually until 05/01/18 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. 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. current to the most recent month ended.**

International Monetary Fund (IMF) is an international U.S.-based organization of 188 countries focused on international trade, financial stability, and economic growth.

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. 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 Diversify 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.



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 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.**