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Growth Divergence

By Eric Fine, Portfolio Manager

VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

Market Review

Generic "emerging markets debt" should remain under pressure, in our view. We see at least four reasons for this view. One, relatively low emerging markets ("EM") growth relative to developed markets ("DM") growth looks set to continue. Two, EM countries that we think are facing idiosyncratic adversity happen to be important index components, thus neither good for sentiment nor flows. Three, the more the market keeps behaving the way it has since the crises in Turkey and Argentina (namely, slowly spreading pressure on a range of countries and asset prices), the more the current situation looks like a contagion event. Four, the market hasn't taken on board what should be a central case of a paradigm shift in U.S.-China economic relations.

EM growth continues to lack inspiration relative to DM growth. The recent activity surveys for emerging markets look weaker than those for their DM counterparts, while the consensus has revised its 2018 and 2019 forecasts for the growth differentials between EM and DM to their lowest levels. Moreover, a number of central banks are in less-dovish/more-hawkish modes as foreign currency weakness pass-through to inflation is digested. Those that don't (e.g., India, which failed to tighten in early October) might (actually, probably almost certainly) be making themselves more vulnerable, as a cushion against future inflation risks is taken away. All things equal, a growth-positive backdrop is positive for emerging markets foreign currencies ("EMFX") and EM credit spread duration, in our opinion, and weak growth is negative. This differential sparked the EMFX selloff in the second quarter of 2018, in our view.

The EM countries facing problems are big ones. We see Turkey as having to reconcile its relationship with the U.S. if it is to have a chance of economic stabilization, due to its acute dependence on U.S. dollar financing (despite a quick turnaround in its trade accounts). However, we see little chance of such a reconciliation. If we are correct on those two points, then capital controls appear inevitable. Despite having the best economic policy in its history as a post-communist independent nation, Russia remains uninvestable, in our view, due to risk of U.S. sanctions escalating to include its bond market. China may be facing a completely new attitude from the U.S., and an attitude that seems increasingly politically popular with both U.S. political parties. That strikes us as a big potential off-sides in the market— the ongoing escalation of tensions seems the central case to us, but we don't see a market discounting that. Finally, we are talking about bank problems in India … one year since these were supposed to have been sorted out: Not good.

If this current situation continues, it will only stop with the Fed backing down, which is very unlikely (i.e., the Fed backing down), in our view. We could be in the midst of a contagion. It is somewhat self-definitional. If countries and asset prices keep coming under spreading financial pressure, there's a contagion. How much it takes before a headline says it is remains a guess. But if it doesn't stop, it'll be a contagion at some point. If so, contagions stop when the Fed does. We see no reasons the Fed would take EM weakness into account. Do you? Especially if some of the economic pressures are emanating from geostrategic competition between the U.S. and China. In such a context, the Fed would be even more circumspect about invoking Chinese economic problems as reason to change his policy. Can you imagine a Fed cutting rates because the Chinese economy is having trouble as a result of bipartisan U.S. efforts to force it to change its behavior on national security issues?

An environment in which "EM debt" is under pressure is a good environment for us, as we can avoid over-owned index names, and get meaningful exposure to over-sold names. We think our outperformance this year was largely due to avoiding pitfalls such as Turkey, and avoiding EMFX in general. We suffered from owning a lot of Argentina, but still outperformed, and were thus able to hold on to something that is simply oversold. We also saw notable policy deterioration in countries that previously showed promise, like Ecuador. Deputy Portfolio Manager David Austerweil visited Ecuador in September, meeting with government officials and private sector analysts. He believes that Ecuador might be heading for a balance of payments crisis in 2019, with the loss of international reserves exacerbated by capital flight, the relaxation of import controls, and the government's encouragement of credit growth. (See his trip report here: Ecuador: Running Up the Down Escalator.) There are other countries we are avoiding, but these have been longer-standing: Russia, Thailand, and Turkey, in particular. However, there are some very exciting situations where the market has thrown the baby out with the bathwater.

Despite being cautious on "EM debt", we are very constructive on a range of USD credits with short duration, including Argentina, China property, Brazilian corporates, and even super-strong South Korea! We see Argentina implementing its IMF deal and avoiding market borrowing for the next two years. As cautious as we are on China generally, locals have oversold USD corporate bonds (to generate cash in uncertain times) that offer very high yields, with low duration, in companies that have high cash to short-term liabilities. In other words, they have an answer to one of our key concerns. Even South Korea is cheap in our framework—it has low spreads, but its spreads are high relative to countries with its fundamentals.

Some "majors" might be set for improvements—Mexico and perhaps Brazil come to mind. We are more constructive on Mexico, and have initiated local market exposure there. Our main concern had been that incoming president-elect Andrés Manuel López Obrador (AMLO) will not be able to credibly finance his spending promises. Having spent a lot of time with relevant finance officials, we have changed our mind for now. In our view, their financing plans are now very credible. Additionally, we'd note that a referendum on a Mexico City airport had been another concern … another possible adverse flashpoint. That, too, seems to be no longer the case, with approval of the airport now expected, according to polls. This change in our stance is an example of how we change our views on "EM local," country-by-country, based on bottom-up factors.

Brazil is very binary. Portfolio Manager Eric Fine was recently there, so please see *Brazil: Binary, Bumpy, Buy?* for his trip report. As the title suggests, everything from the local currency to inflation is dependent on October's two election rounds. The asset price and inflation outcomes for the two different election scenarios are extreme. A Bolsonaro victory could be extremely positive for asset prices. A Haddad victory could be extremely negative for asset prices. We have been approaching Brazil cautiously, but the momentum appears to be on Bolsonaro's side, and there is very little bullish positioning in Brazil, in our opinion. As a result, we have established some exposure to Petrobras in USD (a lower beta view than local currency).

Exposure Types and Significant Changes

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

- We increased local currency exposure in Mexico. The post-election tone of the president and the government officials is more market-friendly than expected, while the economy is gradually improving. The central bank remains vigilant, but the probability of interest rate hikes looks lower. In terms of our investment process, this translates into better economic and policy scores for the country.

- We also increased hard currency sovereign and quasi-sovereign exposure in Brazil and Argentina. Argentina had finally signed the revised deal with the IMF with a larger size to the program and front-loaded disbursement. The new deal (as well as the appointment of the central bank's new governor) reduces room for large-scale currency interventions, which improved the economic and policy scores for the country. In Brazil, we see a non-trivial probability that a more market-friendly candidate will win in the forthcoming presidential elections, which should improve the country's policy score.

- We also increased our hard currency sovereign exposure in Venezuela, Ukraine, and Georgia. In Venezuela, we now see a higher probability of a bond-friendly scenario (which might involve a military option on the part of the U.S.), which improves the country's politics score. In Ukraine, the government is making progress (albeit slow) towards fulfilling the IMF program's conditionality, which translates into the improved policy score for the country. Finally, Turkey's negative macroeconomic impact on Georgia appears to be reasonably contained. Georgia remains on the reform path, while valuations improved during the last sell off. In terms of our investment process, this translates into the improved economic score for the country.

- We reduced hard currency sovereign exposure in Costa Rica and El Salvador. In Costa Rica, the government's decision to start selling bonds to the central bank is tantamount to monetary financing, which negatively affected the country's policy score. In El Salvador, we are most concerned about the uncertainty surrounding the presidential elections, which lowers the politics score for the country.

- We also reduced hard currency sovereign and quasi-sovereign exposure in Ecuador. One of our concerns is that the government appears too desperate to regain market access, going for loans (such as the one from Goldman Sachs) that have strange timing and terms. We think that such desperate moves lower the country's economic and policy scores.

- We also reduced hard currency sovereign exposure in South Korea. We think the country's fundamentals look great, but we wanted to use this position as a funder for more interesting opportunities out there.

Fund Performance

The VanEck Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) gained 1.51% in September compared to a gain of a 2.05% 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 Argentina, Brazil, and, Venezuela. The Fund's least contributors were Costa Rica, South Korea, and El Salvador. Turning to the market's performance, the GBI-EM's biggest winners were Turkey, Brazil and Russia. The biggest losers were Argentina, Philippines, and Czech Republic. The EMBI's biggest winners were Turkey, Argentina, and Venezuela. The biggest losers were Costa Rica, Paraguay, and Trinidad and Tobago.

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	–

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

	1 Mo†	3 Mo†	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	-2.78	-8.48	-6.05	-2.25	0.39	0.60
Class A: Maximum 5.75% Load	-8.33	-13.72	-11.49	-7.88	-0.79	-0.39
50 GBI-EM GD / 50% EMBI GD	-2.02	-7.02	-5.78	-1.89	1.89	–

†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.

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. Certain indicies may take into account witholding taxes. 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 Diversified 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.

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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 below investment grade securities, credit, currency management strategies, debt securities, derivatives, emerging market securities, foreign currency transactions, foreign securities, hedging, other investment companies, Latin American issuers, management, market, non-diversification, operational, portfolio turnover, sectors and sovereign bond risks. 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, and the risk that a position could not be closed when most advantageous. The Fund may also be subject to risks associated with non-investment grade securities.

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.