VanEck®

Emerging Markets Debt: Shaken, Not Stirred

By Eric Fine, Portfolio Manager

VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

Market Review

We outperformed our benchmark by 139bps in February, with the Fund (Class A Share) down 0.80%, compared to down 2.19% for its 50/50 benchmark made up of the GBI-EM and EMBI indices. (The GBI-EM was down 3.41% and the EMBI was down 0.97%) Even though the Fund was approximately 50% invested in the worst-performing local currency segment and even though the hard currency segment also did poorly, it was able to outperform both. This is because the Fund avoided the weakest performers in a market whose components were very bifurcated, especially in local currency. We'll get into more country by country performance description later. Our point is that EM is not a monolith, even in a major global risk-off episode, and there is a range of defensive asset prices, as well as uncorrelated asset prices. These characteristics can be useful for strategies that are bottom-up and that use their flexibility.

We end February with a portfolio that generates 6.7% in carry, has a duration of 6.1 and local currency exposure of approximately 50%. The only change in these portfolio-level metrics was a decline in carry and an increase in local currency exposure. As is normally the case, these changes were the top-line result of country-specific, bottom-up decisions, not a top-down global call on "risk-on" or "risk-off", even though they did defend the portfolio during a "risk-off" month. In particular, we reduced Argentina significantly (from an exposure of approximately 14% to one of approximately 9%), which had a big impact on our carry due to the fact that Argentina's is so high—more details on our Argentina view later. We also increased local currency exposure by approximately 5%, again for bottom-up, country-specific reasons. In particular, we increased our exposure to the Czech Republic and Thailand, which happen to have very low carry. (More on these later, too.) Our top five country exposures are currently Indonesia, Argentina, the Czech Republic, El Salvador and Uruguay, with the Czech Republic a new entrant in the top five and Ukraine no longer in the top five.

Coronavirus's economic impact is the dominant market driver now, the basic implications of which are lower global interest rates and incipient global fiscal stimulus. Global growth was just picking up before coronavirus struck, following the challenges of the "Trade War", and the generally more open EM economies were correctly viewed as being due for a bounce-back. However, the policy response so far is characterized by widespread monetary easing, with the U.S. Federal Reserve's (Fed's) 50bps cut headlining the story and the Bank of Canada's and Reserve Bank of Australia's cuts underlining the global nature of the response. In addition, fiscal stimulus is widely discussed and anticipated, with the U.S. already approving an $8B+ spend and the IMF creating lending facilities and endorsing broad fiscal responses from national treasuries. It is worth noting, though, the European Central Bank's (ECB's) relative inaction, which to us makes sense. As we've argued before, that region's central bank balance sheet expansion resulted in no clear economic expansion and is becoming a poster child for the "reversal rate" (the interest rate below which cuts aren't economically stimulative). As we like to put it, if the ECB keeps rates low, it is undermining its financial system (which is a contingent liability of governments) and if it puts interest rates high, it is undermining economic growth and the credit quality of its governments, especially on the periphery. Only possible German fiscal responses give the region policy space, in our view. This means that in the DM, Europe remains at-risk, as monetary the policy space isn't clear, fiscal stimulus is nascent at best and the region never really grew during the previous experiment with monetary policy.

In EM, coronavirus will initially be a test of national healthcare systems (which are broadly weaker in EM than in DM), but will eventually highlight the monetary and fiscal space of many EM, that could bridge the gap while global stimulus works its way. In our experience of many global health risks, the simple construction we have is that they are tests of national healthcare systems. Those with weaker ones suffer more and vice versa. As generally poorer countries, EM should be viewed as potentially more vulnerable. However, EM also have monetary space, so lower interest rates are a likelier outcome, creating opportunities in local markets. Many EM also have fiscal space, with lower general government debt-to-GDP ratios, almost across the board, compared to the DM. As a result, when the global tide of monetary and fiscal responses to coronavirus arrives on shore, EM have a chance of keeping their bathing suits on and surfing back to shore.

The Czech Republic and Thailand—two of our larger EM exposures—exhibited the defensive characteristics of many EM. In both countries, interest rates declined without significant currency weakness. Moreover, two key central banks—Korea's and Poland's—declined to cut interest rates, despite market pricing. We view this as a sign of strength—of central banks keeping their powder dry and not focusing on ginning up asset prices at every setback (unlike many DM central banks). It also rewards investors in these markets with higher carry.

Other EM countries—Argentina and Ukraine, for example—exhibited the uncorrelated nature of many EM. They were both "positive returners" for our portfolio in February. We've written about them extensively, so we'll just summarize our views. Argentina's is not a story of improvement, but rather a story of being too cheap relative to its fundamentals. We continue to see a liquidity problem, not a solvency problem. We continue to believe that it is likely to stay current on foreign-law USD bond payments as it negotiates. Creditors continue to have the upper hand, as evidenced by the government making principal payments on Province of Buenos Aires bonds in February, as the cost of default far outweighs its benefits. Ukraine's is more a story of incredible reform effort, with a popular president investing all his political capital in unpopular reforms such as land reform. In any case, it, too, bucked the global sea of red.

Our bottom line is that coronavirus's impact on EM asset prices is likely to be temporary and we see a great buying opportunity brewing—now is the time to be looking at offensive strategies, not defensive. To the extent that the limited set of emergency Fed rate cuts in history provides any guidance, we think it is that when the cause of the cuts is addressed, markets are freed to rally. If true, this means that the virus likely has to peak in the U.S., which if China is any guide, is weeks, maybe months, but not quarters, away. EM have fiscal and monetary space. Many EM countries are already exhibiting their defensive and/or uncorrelated characteristics while we wait. The global tide of responses is already brewing close to the shoreline, and once it arrives, it could have a significant impact. Already we hear rumblings among economists of a major "USD down" moment that would be the logical result, especially given the Fed's dramatic move.

A final, more detailed point, on Argentina, where early February saw positive developments. In particular, the Province of Buenos Aires (PBA) backed down from its stance against bondholders quite significantly. Here's the story. PBA initially announced that it was seeking bondholder consent for a postponement of payments (on a bond amortization that was due on January 26, 2019) with no "sweeteners" (i.e., bondholder incentives). The payments were not made on the January 26 due date, raising default risks. But bondholders stood firm and rejected any payment delay. So PBA offered a payment of 30% of principal. And still, less than 75% of bondholders (the level required to change bond terms) agreed. Facing the end of the "grace period" (during which scheduled payments can still be made without a non-payment event), the Province gave up, paying the entire amortization due. Because this was done in coordination with the Argentine republic (where we have the bulk of our exposure), the entire Argentina complex reacted positively in early February, rightly so in our opinion.

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions are currently: Indonesia, Argentina, Czech Republic, El Salvador and Uruguay.

- We increased our local currency exposure in Thailand and the Czech Republic. The market now prices in more policy easing in the U.S. compared to Europe, providing a significant near-term boost to the euro and other European currencies, including the Czech koruna. We also do not expect the Czech National Bank to deliver

another interest rate hike any time soon. In terms of our investment process, this improved the country's technical and policy test scores. In Thailand, the central bank's policy stance is expected to remain very accommodative, given the impact of the coronavirus on the growth outlook. At the same time, the currency will enjoy the protection of large current account surpluses. In terms of our investment process, this strengthens the country's economic and policy test scores.

- We continued to increase our hard currency sovereign exposure in Dominican Republic and local currency exposure in the Philippines. The reasons were the same as back in January—our valuation model places the Dominican Republic's bonds in the second highest valuation bucket, but at the same time their performance lagged the rest of the region, which was not justified by the country's good fundamentals and the structural story. In terms of our investment process, this improved the technical test score for the country. Our valuation model placed Philippine local currency bonds in the highest valuation bucket, which underpinned our decision to go "market-weight". In terms of our investment process, this improved the country's technical test score.
- Finally, we increased our hard currency corporate exposure in Ukraine. Vodafone Ukraine was a new issue: a low-leveraged, "Bucket 1" company in an industry which should prove somewhat resilient even in an economic downturn.
- We reduced hard currency sovereign exposure in Argentina. Even though we continue to have faith in Argentina's story, the country's sovereign bonds look set to enter a turbulent period, as the government readies its initial proposal to external bondholders. In terms of our investment process, this lowered the country's policy test score.
- We also reduced local currency exposures in South Africa and Malaysia. A correlation risk with China was the main reason for our action in Malaysia. In terms of our investment process, this worsened the country's technical score. In South Africa, we increased our exposure going into the presentation of the 2020 budget, as the market was excessively bearish. As we expected, the budget delivered a positive surprise, so we chose to take partial profits on our position, as the country's technical score was no longer super-strong.
- Finally, we reduced our hard currency quasi-sovereign exposure in Mexico and hard currency corporate exposure in China. Even though we remain comfortable with Pemex, these bonds rallied a lot since we bought them and the technical test score no longer looked very attractive. We therefore decided to use them as funders for more promising opportunities. The reduction in China exposure was caused the coronavirus disruptions, which affected the entire economy, significantly worsening the country's economic test score.

Fund Performance

The VanEck Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) lost 0.80% in February compared to a loss of 2.19% 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.

Turning to the market's performance, GBI-EM's biggest winners were Thailand and Philippines. The biggest losers were Indonesia, Brazil and Mexico. The EMBI's biggest winners were Indonesia, Philippines and Brazil. The biggest losers were Ecuador, Turkey, and Lebanon.

Average Annual Total Returns (%) as of February 29, 2020

	1 Mo†	3 Mo†	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	0.80	3.97	-0.16	6.71	1.42	1.97
Class A: Maximum 5.75% Load	-6.48	-1.99	-5.86	0.59	0.22	1.19
50 GBI-EM GD / 50% EMBI GD	-2.19	0.94	-2.07	6.73	4.05	2.95

Average Annual Total Returns (%) as of December 31, 2019

	1 Mo†	3 Mo†	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	4.14	4.40	12.61	12.61	1.53	2.04
Class A: Maximum 5.75% Load	-1.84	-1.67	6.05	6.05	0.33	1.23
50 GBI-EM GD / 50% EMBI GD	3.07	3.51	14.31	14.31	4.57	3.30

† Monthly returns are not annualized.

Expenses: Class A: Gross 2.05%; Net 1.26%. Expenses are capped contractually until 05/01/20 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.

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 indices may take into account withholding 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.

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666 Third Avenue | New York, NY 10017
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