Emerging Markets Debt: Back up the Truck!

By Eric Fine, Portfolio Manager

VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

Market Review

We underperformed our benchmark significantly in March. The fund (Class A Share) was down 19.89%, compared to down 12.46% for the fund’s 50/50 GBI-EM/EMBI benchmark. Herein, we will focus more on performance and future scenarios, as we’ve written several pieces over the past two weeks that go into more detail about what has happened, how and why it happened, and why we think now is the time to “back up the truck” and prepare to load up during the “Sale of the Century?” Suffice it to say, we think that 6 months from now, current prices on many EM bonds may look like steals. Please visit our website to view additional research including the below three timely pieces.

- “Sale of the Century?”, in which we describe Fed actions and their help for EM, why EM should acquit itself again, as it did after the GFC, and a country-by-country description of why we really like our asset prices in the current environment.
- Why EM Should Acquit Itself Again”, in which we list some general and then some country-specific bullet points as to why we think the nearly ubiquitous bearishness on EM is misplaced, and underlines the buying opportunity. Many investors approached us saying they’d like to buy, but higher-ups with limited EM experience want to either buy US stocks, or pile into treasuries, which strikes us as a psychological reaction, not a process-oriented reaction.
- “Why Covid-19 Might not be as Bad for EM as You Might Think”.

We own our underperformance and are not making excuses. We want to emphasize, though, that mid-car-wreck is not the time to figure out which are totaled and which will cruise. A report from Goldman Sachs says almost all funds underperformed and most EMBIG-based funds are down around 17.5%. Some of the popular ones are down anywhere from 20% to 35%. Check your Bloomberg screens for your favorites, await proper eVestment data, and recall that pricing is very hinky for corporates, of which we have under 10% in the fund.

We aren’t just saying now’s the time to focus on a rebound - we increased risk in March, during the selloff, and despite our underperformance, our purchases are higher in price than when we accumulated them. We sold relative winners such as Czech, Thailand, and Philippines in local currency, and increased Mexico in local currency and Angola in USD. The team has built a range of outcomes they expect for their portfolio, based on bottom-up scenarios and V-shaped, U-shaped, and L-shaped global economic recoveries. Though we won’t display them here, please reach out and the team is happy to review them.

Summary/Key Observations:

- Oil prices don’t seem to matter that much to our portfolio. The logic (emanating from the scenarios) is that the oil-related asset prices are low and priced adversely for a restructuring already. This is consistent with our point that things like Angola and Argentina went down as much as Lebanon and Ecuador, the latter two actually defaulting. (I know Lebanon is not an oil story, we’re just making a general point).
- “Risk-free” duration is logically vulnerable in the event of any sharp market recovery, as duration gets destroyed with no carry in that scenario.
- A U-shaped global market recovery could really make high-carrying stuff shine (meaning EM-type of asset prices, namely liquid sovereigns and liquid high-carrying local).
Manager Commentary  March 2020

- Oil either returns to 50 by year-end (not the average price for the rest of the year, just the end-point), or it languishes where it is. This mostly affects Angola, Mexico (Pemex, especially), and the few oil corporates we have that are at very low prices.

- Argentina either does a deal with creditors in the next 3-6 months (highly likely...everyone wants it done, even more-so now, with the question being how long they stay current), or the negotiations break down and there's a credit event (i.e., non-payment on NY-law debt). We are only referencing NY-law, USD-denominated short-dated debt, most of which we unfortunately closed before Covid-19 crushed all asset prices as March headwinds knocked down every house. We currently only own the CHF bonds maturing in October 2020. A key constraint on the Argentines is to keep prices not too low in order to prevent “vultures” from getting commanding positions. Note they surprisingly (to the market, not to us) paid a key coupon last Friday, consistent with our view. FWIW, our market color is that there are only buyer orders out there that are not able to get filled at current prices.

In our “Sale of the Century?” piece we detailed our current exposures and why we like them; below is a summary version.

- Angola has an IMF program and mostly bilateral debt (i.e., easily termed out), though it is expensive debt.
- Ukraine just doubled the size of its IMF program.
- Indonesia increased fiscal spending and looks like it may get it all financed by official lenders.
- South Africa didn’t trade poorly after the Moody’s downgrade we expected and has ready access to official funding if requested.
- Mexico has the highest real rates in the world (for the majors), has Fed FX swap lines, and benefits most when US fiscal stimulus gains traction.
- Argentina might default, leading perhaps to prices of approximately 50 cents, and their bonds are currently priced at 25 cents (we also reduced 1/3rd of our Argentina exposure before the selloff, leaving us with mostly performing provinces and corporates, and room to repurchase the bonds we sold).

We end March with a portfolio that generates 10.0% in carry, YTM of 13.7% (ex-Argentina, which will reschedule debt, so including them in YTM would be misleading), duration of 5.3, and local currency exposure at around 50%. Corporates are under 10% of the fund, and we reduced these, too, prior to the Covid-19 selloff.

Some important, additional, unique risks to some of our positions. Our Investment Committee (with whom we meet weekly), asked some out-of-the box questions related to Covid and oil, that we thought were interesting and merited referencing. The four risks were oil prices, tourism, remittances, and willingness to pay. We’ll be brief and try to be specific to our exposures on each one (not make general comments on any of these risks’ impact on “EM”). Note that in our “Sale of the Century?” piece we touch on the cases for our exposures more completely.

- Oil: Here, the best answers are as follows, and consistent with it not being a key risk to our fund, in our view. We don’t have that much - only around 10% direct oil exposure. Our model scenarios make the key point that they aren’t the key driver of performance, due to the level of our exposure and that it is very priced into the asset prices we chose. Additionally, many of our countries (South Africa, Dom Rep, El Salvador, and even Indonesia stand out) are net importers. Also, most EMs have large energy components in their CPI baskets, so benefit from lower inflation/higher real interest rates. Angola for sure is exposed to oil prices. But, as we note above and elsewhere, the bulk of their liabilities in 2020 are bilateral and likely to be rolled, they are running a 7% of GDP primary fiscal surplus, and the IMF (partially due to this commitment) has been very supportive of them during a collapse in oil prices over which they had no control.

- Tourism: This is a risk to Dominican Republic, even if mitigated by lower oil prices. It is also a risk to Mexico and Indonesia, though less-so. Overall, we’ve reduced our global tourism exposure significantly by closing Thailand and the Philippines (with tourism being only a part of the rationale). Uruguay technically has some tourism exposure, but that was manifest long ago during the Argentine crisis, as most tourists emanate from there. And, Uruguay’s other strengths outweigh this downside, in any case.
**Manager Commentary  March 2020**

- **Remittances:** This is a risk to El Salvador, and we’re in the process of examining it. It is also a risk to Mexico, but one that is better understood. In both countries you have pretty orthodox policy and very good relationships with international lenders like the IMF. But, they are risks, and we’re looking into them. Philippines is also subject to this risk, but we’ve closed that exposure.

- **Willingness to pay:** In emergencies, country’s institutions are tested just as are individuals. It is tempting to say “we’d love to help, but Covid is making me (fill-in-the-blank for whatever adverse of unfair decision one wanted to make and was just awaiting an excuse). Historically, Argentina has to top the list of low willingness to pay. But at 25 cents on the dollar, that is not an un-priced risk. We must also note that the country’s reaction to the global crisis so far has been better than even we expected. They just announced a term-out of local-law USD debt, and reiterated they want to stay current on foreign-law USD debt, on which they just paid a coupon days ago. El Salvador, too, has a spotty history, with debt payments being a political hostage recently. It’s a risk, but one we think is mitigated by the new president’s orthodoxy and strong relationship with the US and the IMF. Angola has had a tricky history, but it has a very reformist new government and is running significant primary fiscal surpluses despite hardship. Zambia, by contrast, seems to be up to its usual reaction of using any excuse to stop payments. We have no exposure there. Ecuador and Lebanon (neither of which do we own) are also in the midst of defaults, and even though these are not out-of-nowhere, our worries about their willingness to pay kept us from owning them even though Step 1 of our investment process told us their bonds were cheap relative to fundamentals.

**Exposure Types and Significant Changes**

The changes to our top positions are summarized below. Our largest positions are currently: Indonesia, Mexico, Argentina, Dominican Republic, and Ukraine.

- We increased our local currency exposure in Mexico (South Africa grew due to price appreciation during the period, not additions). Mexico’s rates and FX were hit especially hard during the sell-off due to (1) the economy’s close connections with the U.S. and (2) their super-liquid/regional proxy status. Meanwhile, the country’s fundamentals are yet to show any significant deterioration. In addition, Mexico secured a sizable (USD60bn) FX swap line with the U.S. Federal Reserve, and it already started to tap into it. On top of that, President Lopez Obrador’s policy statements are getting more and more orthodox with every passing day, while the central bank’s independence was never in question. Both the Mexican peso and local bonds now look extremely cheap in our valuation framework. These improved valuations boosted the country’s technical test score big time. South Africa’s recent macro story has a lot of dark chapters, but a lot of negativity – including a loss of investment grade status – is already priced in. Further, the central bank made a courageous decision to start its own QE program, providing support for the local bond market in this difficult time. In terms of our investment process, this improved the country’s policy and technical scores.

- We continued to increase our local currency exposure in Indonesia. We also added some hard currency quasi-sovereign exposure in Indonesia. The country continues to look very attractive in our valuation framework. On the macro/policy side, even though the government decided to temporarily lift fiscal deficit cap, authorities approached multilateral financial organizations with requests to upsize its loans in order to help financing it. In terms of our investment process, this improved the country’s policy/politics test score.

- Finally, we increased our hard currency sovereign exposure in Gabon and hard currency sovereign and quasi-sovereign exposure in Mongolia. Both countries’ valuations improved greatly after the selloff, strengthening their technical test scores. Oil remains a very important driver for Gabon. However, the economy is more diversified compared to regional peers, which also improves the country’s economic test score. It also has very low levels of near-term debt obligations. As regards Mongolia, this is a good proxy on China’s improving activity, which should be beneficial for at least some commodities, such as copper.
We reduced local currency exposure in Thailand and the Czech Republic. We refer to these countries as “EM graduates”, which is a reflection of their high level of economic development and policy-making. This status notwithstanding, local bonds in both Thailand and the Czech Republic looked cheap relative to their fundamentals going into the COVID-19 crisis, and we happily had them in the portfolio. They performed their intended role, shielding us at the time of need. Their valuations no longer look as attractive, which means the worsening technical test scores. We followed our investment process, reducing this exposure and allocating the funds to other – more attractive – opportunities.

We also increased hard currency sovereign exposure in Angola, but its price drop made it look like a reduction. We also increased in Belarus. Angola is an extremely oil-centered economy, which we view as a major disadvantage right now – despite having an IMF program and doing the right stuff on the structural front. We think that the oil connection will continue to weigh on the country’s economic test score, but we stand ready to increase further because many bonds are trading at a default levels. As regards Belarus, we had this position for a long time. It performed well, and with time its technical test score started to erode. We therefore decided to use it as a funder for other positions.

Finally, we reduced hard-currency corporate exposure in Brazil. During March, we did weed out some of the weaker balance sheets in our corporate portfolio as we became more concerned about economic activity, the decline in oil prices, and the possibility of higher refinancing hurdles that might be faced by companies in our portfolio.
Fund Performance

The VanEck Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) lost 19.89% in March compared to a loss of 12.46% 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 losers were Indonesia, South Africa and Mexico. The EMBI’s biggest losers were Ecuador, Mexico, and Angola.

Average Annual Total Returns (%) as of March 31, 2020

<table>
<thead>
<tr>
<th></th>
<th>1 Mo†</th>
<th>3 Mo†</th>
<th>YTD</th>
<th>1 Yr</th>
<th>5 Yr</th>
<th>Life</th>
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<tbody>
<tr>
<td>Class A: NAV</td>
<td>-19.89</td>
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<td>-20.01</td>
<td>-14.91</td>
<td>-2.67</td>
<td>-0.94</td>
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<tr>
<td>50 GBI-EM GD / 50% EMBI GD</td>
<td>-12.46</td>
<td>-14.28</td>
<td>-14.28</td>
<td>-6.61</td>
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Average Annual Total Returns (%) as of December 31, 2019

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<th></th>
<th>1 Mo†</th>
<th>3 Mo†</th>
<th>YTD</th>
<th>1 Yr</th>
<th>5 Yr</th>
<th>Life</th>
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</thead>
<tbody>
<tr>
<td>Class A: NAV</td>
<td>4.14</td>
<td>4.40</td>
<td>12.61</td>
<td>12.61</td>
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<tr>
<td>50 GBI-EM GD / 50% EMBI GD</td>
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<td>14.31</td>
<td>14.31</td>
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<td>3.30</td>
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† 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 vanec.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.

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