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China's Reopening Good for EM Debt

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VanEck Emerging Markets Bond Fund

EMBAX | **EMBUX** | **EMBYX**

Overview

In December, the Fund returned 2.82%, compared to 1.24% for its benchmark, the 50% J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified and 50% J.P. Morgan Emerging Markets Bond Index (EMBI), generating outperformance of 158 bps. Year-to-date (YTD), the Fund outperformed its benchmark by 700 bps, with the Fund returning -7.73%, compared to its benchmark returning -14.73%. We continue to see a good setup for the Fund and will quote again that "China was the sole performance-detractor (for the Fund)...but the Fund held on to its China property names....making China's reopening and policy support for the sector a big winner for that view." The Fund also benefited from this. As of end-December, local currency exposure was 44.48.

We see three key U-turns going into 2023: 1) China reopening, 2) a hawkish Fed and 3) a looming U.S. recession. In China, markets spent 2022 digesting the property sector collapse and strategic divorce with the U.S., and are only slowly waking up to China reopening. This is very supportive of commodity prices, Asian EMFX and specific Chinese credits. 2) The U.S. Federal Reserve (Fed) and inflation dominated the bond narrative in 2022, but this was capped by two roughly 100 bps rallies in 10-year yields in the second half of the year, as the bond selloff became exhausted as part of an "everything" rally—with "everyone" now bullish bonds for the new year! This is a setup for another selloff in bonds and a hit to risk-free duration and some spread duration. 3) Growth was not a key market driver in 2022, but despite continued growth momentum in the U.S., 2023 will end up being a discussion of how bad the U.S. recession will be. This argues for caution and selectivity on spreads, spread duration and risk generally.

Overall, the above describes a bumpy world with few obvious thematic opportunities, other than EM debt. In Emerging markets (EM) debt stands out with asset prices that can benefit directly from China's reopening. It stands out with its high-carry bonds that can generate a return in a potentially sideways or bumpy bond world. Many EMs stand out as beneficiaries of higher commodity prices, not victims of them. EMs largely have independent central banks that hiked interest rates early and more than developed markets (DM), making inflation less of a worry in EM than in DM. For now, we continue to favor Asian EMFX, China property and selective high-spread sovereigns, and are looking to reduce low-beta duration.

China's reopening. Last year was dominated by the property sector collapse and exiting China permanently. This year will be about chasing a rally for which no one is positioned. China's reopening is a key new unpriced market driver. This was a key risk (the risk of reopening) to which the market did and does not have much exposure and is a big part of why the fund shifted so much to Asia in recent months. After rumors and hints of a change in China's 0-COVID policy, it now looks like China has significantly loosened controls; this is a clear change in policy. It is also accompanied by the increasingly accommodative macro policy and by very supportive structural policies—the government keeps encouraging the resolution of defaults and non-payment in the country's property sector (Chinese property and some growth-sensitive HY bonds are our exposure in China). The market responded by making Asian currencies, such as the Thai baht and Indonesia rupiah (among our biggest overweight exposures), and Chinese corporate bonds explode upward in price. To be clear, our stance was not that it was a certainty that China would reopen; our view was that reopening risk was not reflected at all in selected asset prices such as Asian FX and Chinese property bonds. Those asset prices had the biggest upside risk. We also saw them as having very limited downside risk, as there had already been a de-risking from Asia—there was and remains extremely low exposure to Asia, in our opinion.

Commodities supply remains a risk with the advent of Eurasia and other geopolitical developments. EM and Asian economies, in particular, could de-couple positively, yet again, from DM. Eurasia's development is a form of resource war and risk to commodities supply for the DM. We showed a map of Eurasia in our last monthly commentary, which is the best simple explanation of our view. Central Asia is surrounded by Russia, China and Iran. That region and all the economic/financial/security structures that have been built are a new economic entity to which "the West" will have no access. It should take until 2025 for Russia's oil and gas pipelines to be re-directed East, but it is well underway. This is a profound tailwind for the region's growth and financial development. It is also a profound tailwind for the DM, which has lost access to Eurasia. In fact, China and Russia's leaders have laid out currency bloc plans on the back of all of their structures, so don't be surprised when you see digital gold and other currency arrangements that wean the world off of USD (and by definition off of EUR and JPY).

These drivers are bullish for commodities, Asian growth and, to the extent that supply chains truly revert, disin lation. It is not bullish for U.S. and DM inflation nor U.S. and DM growth, because U.S./Europe/Japan are excluded from the Eurasian century. As a result, China's reopening is positive for China and commodities, but that's it. It could be outright negative for DM risk-free rates (the Fed doesn't control food and energy prices, after all) because the DM will get the inflation risk without the growth. **Stagflation could increasingly define DM.**

A hawkish Fed. Last year, markets over-digested a hawkish Fed twice, with two roughly 100 bps rallies (June and October), but bearish rates were still the right view for the year. We see the same for 2023, so we will again operate with a core rates-higher view with tactics around that view. There's one key difference: yields are higher and selected bonds have a better chance of performing than they did in 2022.

Anyway, as a result, curve inversion in the U.S. treasury market seems to be the wrong reaction. We get the "everything rally" and were positioned for it. But what about next year? Inflation may not be low enough to let the Fed cut 70 bps after May, which the futures market is predicting. That's 70 bps of risk-free yield that could be easily challenged next year, without invoking other "off-sides". Similarly, rising recession risks (and deeper recessions) mean that spreads could also come under upward pressure. Nowhere to hide, in other words. Unless, of course, you are nimble on duration and active in investing. To be super-clear, the market has, in our view, been too complacent in thinking that the turn-in rates are the turn-in risk. Our view is that "the turn-in rates is not the turn-in risk". First, rates are rallying due to technical—there was too much bearishness, so fundamentals weren't able to express themselves in this period. Second, the Fed can't be happy with risk-on and an easing in financial conditions as they are hiking. Third, the path of inflation might not give the Fed an opportunity in 1H 2024 to say that their policy rate is higher than the inflation rate. Related, we are in a world of headline inflation—core, which the Fed targets—excluding food and energy, and like we said the Fed has limited purchase on food and energy prices. Most people, on the other hand, focus on headline inflation; this underlines the risk.

Looming U.S. recession. Last year, excessive growth was the concern. As 2023 proceeds, we think the depth and breadth of the U.S. recession will become the focus. Especially if we're correct in thinking the U.S. is characterized by a confidence crisis. So what? China's reopening with many commodities facing supply risks is bullish for commodity prices, Asian EMFX and selected property and other credits in China. A hawkish Fed plus an eventual recession means caution on duration for now and nimbleness later. A recession also means caution on spreads and spread duration eventually.

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions in December were Indonesia, China, Mexico, Malaysia and Thailand.

- We increased our local currency exposure in Brazil and Indonesia. We think that Indonesia is well-positioned to benefit from China's reopening and the associated inflows. In terms of our investment process, this boosted the technical test score for the country. Disinflation, fiscal prudence, the improving current account balance, and the central bank's proactive rate hikes are a boon for Indonesia's economic and policy test scores. As regards Brazil, the market has priced in a lot of negativity stemming from President-elect Lula's populist policy stance, especially on the fiscal front. At the same time, the transition team made a concerted effort to project a more fiscally responsible image, while the parliament curtailed the new team's fiscal ambitions, approving larger spending for one year only. Improved valuations and ongoing disinflation provided a supportive backdrop in the form of better technical and economic test scores. We are not convinced though that we've seen the end of the new administration's fiscal push or attempts to roll back reforms—so we stand ready to adjust this position if necessary.

- We also increased local exposure in the Philippines and South Korea. Similar to Indonesia, South Korea can get a boost from China's reopening, and entrenched disinflation suggests that the central bank is close to the end of its tightening cycle. In terms of our investment process, this improved the technical and policy test scores for the country. Philippine inflation is yet to reach its peak, but the central bank is very credible, signaling that it will continue tightening until price pressures start to ease (and improving the policy test score for the country along the way).

- Finally, we increased hard currency sovereign exposure in Saudi Arabia and hard currency quasi-sovereign exposure in China. A big portion of China's increase was due to price changes, as high yield instruments (especially developers bonds) rallied on the reopening news and new sizable (and more specific) policy support. We also added a longer-dated quasi-sovereign bond to better express these trends (and the improving policy test score for the country). We believe that China's reopening should ultimately be beneficial for commodity prices (due to stronger growth), and having exposure to commodity exporters like Saudi Arabia is a good way to express this theme. In terms of our investment process, this improved the technical test score for Saudi Arabia.

- We reduced our local and hard currency quasi-sovereign exposure in South Africa, and hard currency sovereign exposure in Mexico. We started to have concerns about the outlook for the global duration (as the market might be overestimating room for 2023 rate cuts in the U.S.), and sovereign bonds with a very long duration (like our Mexico holding) might be adversely affected under this scenario. In terms of our investment process, this worsened the technical test score for the country. South Africa suffered from a major bout of political noise at the end of the year—a soft coup attempt against President Ramaphosa, which significantly worsened the policy test score for the country. Even though the situation was successfully resolved, we prefer to stay on the sidelines for a while and wait for further economic and policy signals.

- We also reduced our hard currency corporate exposure in Colombia and hard currency corporate and sovereign exposure in Ghana. Colombia's reduction affected positions with very low spread-to-yield ratios (effectively U.S. Treasury proxies)—this particular feature worsened the technical test score. As regards Ghana, the debt restructuring saga continues, and there is a lot of resistance on the part of local institutions to accept the government's vision for local debt restructuring. In terms of our investment process, this worsened the policy test score for the country.

- Finally, we reduced our hard currency sovereign exposure in Tunisia and El Salvador. The Tunisian bond rallied a lot, and we thought it would be prudent to take profits before the year-end, as valuations looked less compelling, worsening the technical test score for the country. In El Salvador, the government's second bond tender was rather small—a potential sign that liquidity conditions are far from perfect (against the uncertain external backdrop and the current account deficit approaching 9% of GDP). This negatively affected the technical and economic test scores for the country.

Average Annual Total Returns (%)

As of December 31, 2022	1 Month†	3 Month†	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 7/9/12)	2.82	10.32	-7.73	-7.73	-0.64	0.67	0.27
Class A: Maximum 5.75% Load	-3.09	3.98	-13.04	-13.04	-2.58	-0.52	-0.33
Class I: NAV (Inception 7/9/12)	2.93	10.43	-7.21	-7.21	-0.30	1.00	0.59
50 GBI-EM GD / 50% EMBI GD	1.24	8.30	-14.73	-14.73	-5.64	-1.85	-0.17

As of September 30, 2022	1 Month†	3 Month†	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 7/9/12)	-6.31	-2.20	-16.36	-17.99	-2.45	-1.34	-0.12
Class A: Maximum 5.75% Load	-11.70	-7.82	-21.17	-22.70	-4.35	-2.50	-0.71
Class I: NAV (Inception 7/9/12)	-5.98	-1.95	-15.98	-17.60	-2.09	-1.00	0.19
50 GBI-EM GD / 50% EMBI GD	-5.62	-4.63	-21.27	-22.44	-7.06	-3.21	-0.63

† Returns less than one year are not annualized.

Expenses: Class A: Gross 2.33%, Net 1.28%; Class I: Gross 1.74%, Net 0.96%. Van Eck Associates Corporation (the "Adviser") has agreed to waive fees and/or pay Fund expenses to the extent necessary to prevent the operating expenses of the Fund (excluding acquired fund fees and expenses, interest expense, trading expenses, dividends and interest payments on securities sold short, taxes and extraordinary expenses) from exceeding 1.25% for Class A and 0.95% for Class I of the Fund's average daily net assets per year until May 1, 2023. During such time, the expense limitation is expected to continue until the Board of Trustees acts to discontinue all or a portion of such expense limitation. Please note that, generally, unconstrained bond funds may have higher fees than core bond funds due to the specialized nature of their strategies.

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Definitions

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.

Carry is the benefit or cost for owning an asset.

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