September 2021

Red Swan?

VanEck®

Eric Fine

Portfolio Manager

VanEck Emerging Markets Bond Fund

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Market Review

Many China risks remain unpriced, in our view. Most important, China's property sector bonds still don't fully reflect risks. And, as we wrote in "China's Evergrande Collapse is Spreading", we see this flowing through to an already-weaker Chinese economy and a weaker Chinese currency (over quarters). This is a major challenge for high-beta[1] emerging markets foreign currencies (EMFX), especially. (We have updated China property bond, growth, and other charts below.)

The Fed adds to stagflation[2] risks. In addition to the "stagflation" scenario we noted in our last monthly, the Fed is now home to new and proximate risks that seem unpriced to us. The trading scandal is undermining Fed credibility. At the same time, the prospect of four new voters, including a replacement for Fed Chair Jerome Powell, likely means a more dovish Fed. At the least, these represent uncertainty. This uncertainty probably means another leg of the risk-off trade. It also probably means a steeper yield curve, though bounded by China and the absence of further stimulus developments in the U.S.

There remain plenty of attractive—albeit more uncorrelated or defensive—emerging markets (EM) bonds. Zambia is moving towards an IMF agreement, Ecuador's policy (and IMF agreement) continue to bear fruit, Peru's new government is becoming even more market-friendly, El Salvador's bonds are cheap enough to reflect near-term risks and they've received a boost from their bitcoin strategy, etc. Also, one of our longstanding points is that many EM countries have plenty of U.S. dollar assets relative to dollar liabilities, so the dollar bonds of a number of countries that might have other problems, remain very defensive in our opinion (the song would be titled: 'Ninety-Nine Problems but Dollars ain't one'). Brazil, Chile, Colombia, South Africa and others are among these.

The Fund was down -2.72% based on its net asset value in September, slightly outperforming its benchmark, 50% J.P Morgan Emerging Markets Bond Index and 50% J.P. Morgan Government Bond Index-Emerging Markets, which was down -2.75%. Year-to-date (YTD), the Fund was down -2.68%, outperforming its benchmark which was down -3.87%. Our low exposure to EMFX helped the Fund in September and we think EMFX weakness will continue. Our exposure to some higher-risk USD-denominated bonds hurt the Fund in September, but we think that weakness is temporary.

We are notably more defensive on EM debt, with roughly 60% of the Fund in hard currency, duration of 5.4 and carry[3] of 5.2%. We continue to favor Mexico, Brazil, South Africa and, now, Peru and UAE are among our top exposures.

China remains the source of risks that could map adversely in general, and to high-beta EMFX, specifically.

We have four key reasons for this view. First, ongoing contagion in China's offshore bond market remains an under-appreciated risk. Second, China's growth trajectory is hiccupping, at least—it led the globe out of the Covid shock, so why shouldn't it continue its leadership. Third, there is now more evidence for a "stagflation" scenario in the U.S. and global economy, with key implications (many adverse) for the markets that we focus on. Fourth, we see this ending with pressure on China's currency, which would directly affect EM currencies, in our view.

[1] Beta is a measure of the volatility or systematic risk of a security or portfolio compared to the market as a whole. A security with higher beta carries more risk than a security with lower beta.

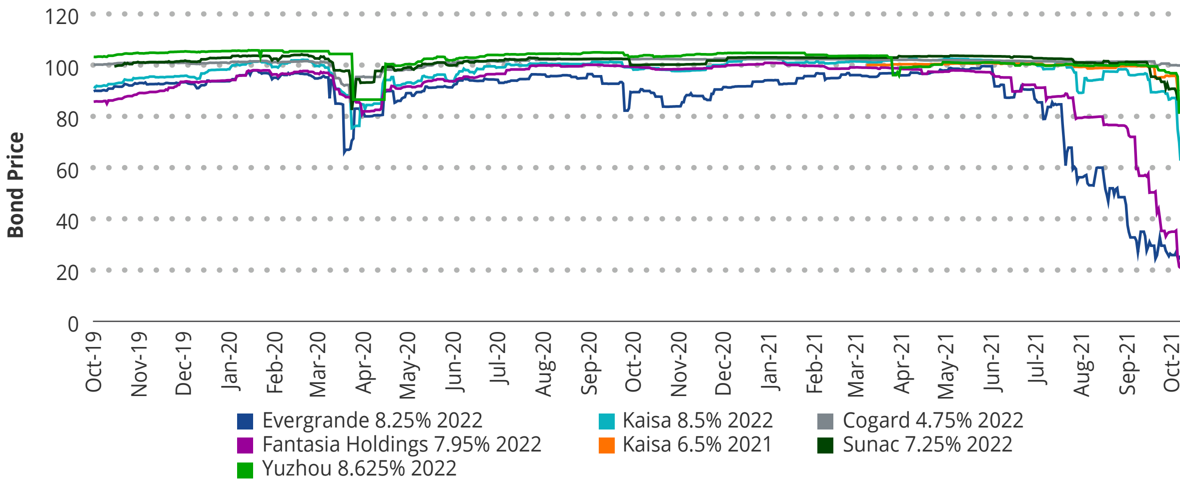
[2] Stagflation is defined as a period of inflation combined with a decline in gross domestic product.

[3] Carry is defined as Current Yield. 30-Day SEC Yield for Class A was 3.78% as of 09/30/2021.

China's offshore bond market is still selling off dramatically.

We've updated our bond collapse chart below. The key change is that Evergrande has spread to other low-rated bonds. Our simple view remains that the entire sector has not yet priced new risks discovered by Evergrande. See our piece "China's Evergrande Collapse is Spreading" for more details, but the basic risks discovered are as follows. The government seems uninterested in supporting offshore bondholders. Evergrande alone (but it is now joined by other developers) should result in lower property prices, as developers lower prices, but more importantly as consumers completely change their attitudes. Property development and real estate account for around 28% of Chinese GDP and roughly half of household wealth, so this has to hit growth. Government support is problematic because everyone expects it and so far its interventions have not prevented Evergrande risks from spreading, and they have been very bondholder-unfriendly in addition.

Exhibit 1 – More Property Bonds Converging to Evergrande

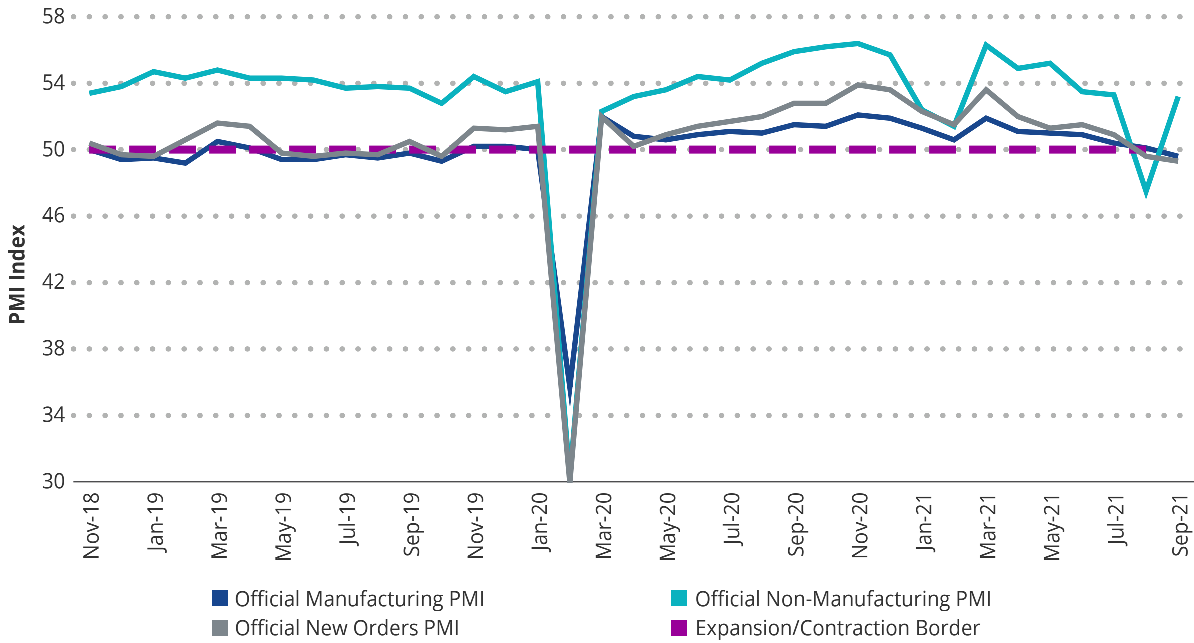


Source: Bloomberg, VanEck. Data as of October, 2021.

The Chinese growth rate is declining, with energy constraints the latest challenge; given China's leadership role in the global recovery, this is worth worrying about.

The causes are manifold, but include the delta outbreak/movement restrictions, supply chain issues, high freight prices and, now, energy shortages. These, though, are likely temporary. The more worrisome cause would be the regulatory overhaul which state media has called a "profound revolution". That does not sound like something that is "transitory". Anyway, the latest activity gauges show that tighter regulations, supply shocks, and logistical bottlenecks continue to weigh on the industrial sector. The official manufacturing PMI (Purchasing Managers' Index) slipped into the contraction zone (49.6) in September—for the first time since February 2020—and details show that deterioration was widespread. This month's small companies PMI moved deeper into contraction zone, reaching the lowest point since February 2020 (47.5). Recent reports indicate that some supply side constraints might be easing (first of all in Asia), but it is probably too late for this year and this factor will limit China's manufacturing rebound in the fourth quarter (especially in energy-intensive sectors). The on-going weakness in new orders (see chart below) and new export orders also point to near-term demand-side growth headwinds. Against this backdrop, it is noteworthy that authorities are not in the mood to reopen credit spigots and continue to dispense policy support sparingly. There are also no signs of easing the regulatory crackdown or giving up on the environmental targets. The emphasis right now is on providing adequate liquidity (the central bank's almost daily injections) and limiting Evergrande's spillovers into the real economy.

Exhibit 2 – China PMIs in Contraction

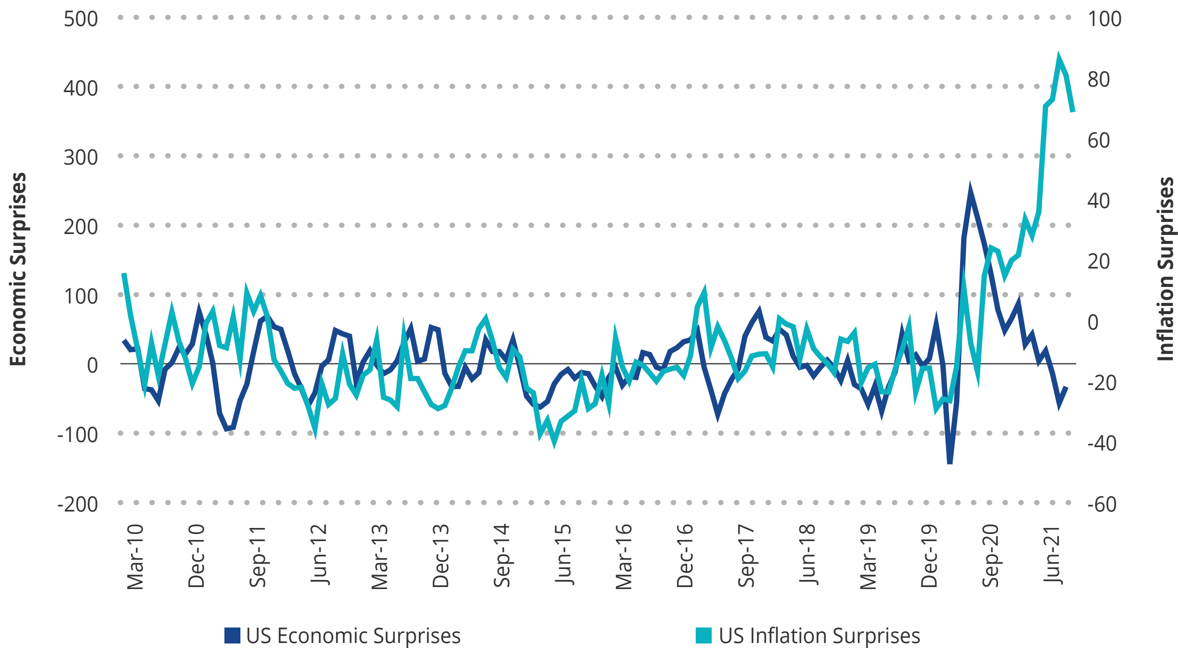


Source: Bloomberg, VanEck. Data as of 09/30/2021.

The "stagflation" scenario we worried about in our last monthly is now exacerbated by risks at the Fed.

First on stagflation—high inflation and low growth are problematic for risky assets and weak bond and stock markets are a perfect reflection of this scenario. Our stagflation charts are updated below. Our only point remains that this is a tough environment for Chinese economic weakness.

Exhibit 3 – Inflation Surprises Up, Growth Surprises Down



Source: Matthew Sigel, VanEck's Head of Digital Assets Research. Data as of 09/30/2021.

We continue to think China may be heading for an external adjustment, i.e., a weaker currency.

Very simply, if capital account flows are challenged by Chinese policy, and global "stagflation" challenges current account flows, China will need dollars. The only option in this scenario would be to reduce the value of the currency (perhaps with increased capital controls, though Chinese policy is already implicitly re-imposing them). This will take several quarters to play out, if it does, but bears watching. Related, Chinese real estate prices strike us as central to China's future. Real estate sales and construction together account for around 28% of GDP and the stock of real estate accounts for around half of household wealth. China's "common prosperity" policies would seem to point toward lower real estate prices, moreover, though some argue that this will be met by low-income housing construction. Anyway, our point is that if China was experiencing problems in other sectors, we wouldn't be as concerned. Below is a new chart, in which we show the relationship between Chinese relative interest rates and its currency. The main point is that if China is going to use monetary policy to address growth concerns, which is expected, it would be reasonable to worry about related currency weakness.

Exhibit 4 – Chinese Interest Rates and Currency

Source: Bloomberg, VanEck. Data as of 09/30/2021.

Exposure types and significant changes

The changes to our top positions are summarized below. Our largest positions in September were: Mexico, Brazil, Peru, United Arab Emirates and South Africa.

- We increased our hard currency sovereign and quasi-sovereign exposure in Saudi Arabia and Qatar, and hard currency quasi-sovereign exposure in the United Arab Emirates. These countries' macroeconomic fundamentals benefit from higher oil prices and past cyclical support. Fiscal balances in the region are expected to be in surplus and this means that issuance "overhang" is out the way. International reserves are also on the mend. In addition, regional governments are delivering on structural reforms. Finally, quasi-sovereign credits have attractive valuations (top initial allocation buckets). In terms of our investment process, all three test scores for these countries—economic, technical and policy—now look stronger.

- We also increased our local currency and hard currency quasi-sovereign exposure in Israel, and local currency exposure in the Philippines. In Israel, we were attracted by the solid recovery and a very credible central bank, as well as attractive valuations (initial allocation bucket #2). Israel's hard currency instruments also tend to outperform during market upheavals, acting as "safer haven" assets. These considerations improved the country's technical test score. As regards the Philippines, we were comfortable covering an index underweight due to relatively cheap short-term currency valuations (equals an improved technical test score). However, we continue to pay attention to high inflation, President Rodrigo Duterte's succession saga and the bumpy recovery.

- Finally, we increased our hard currency sovereign and quasi-sovereign exposure in Brazil and hard currency quasi-sovereign exposure in Singapore. Brazil's political and policy environment is extremely noisy right now—and will probably stay this way during the pre-election period—however, the country's external balance is absolutely solid (a combination of the basic balance surplus and very high international reserves), while the sovereign curve is very steep. In terms of our investment process, this translates into the improved economic and technical test scores. As regards our corporate addition, this was an attractively-valued investment grade credit in a high yield country. Our choice of Singapore's exposure was driven by "flight to safety" concerns, against the backdrop of China's regulation and real estate crackdown and the ensuing improvement in Singapore's technical test score.

- We reduced our hard currency corporate exposure in China and hard currency sovereign exposure in Egypt. China's property sector story took a turn for the worst, with one of the major real estate developers (Evergrande) failing to make an interest payment on its U.S. dollar-denominated bond. The sector's role in the economy is very significant and authorities are trying to reduce the spillovers, but there are no signs of easing the regulatory crackdown, which seems to be affecting other companies' bond prices. Given the big deterioration in the governance, company and technical test scores for Evergrande (and technical test scores for other real estate companies), we decided to close this position completely. The main reason for exiting our sovereign position in Egypt was a surprising additional bond issuance, despite an unfavorable market backdrop. The government's move worsened the technical test score for the country.

- We also reduced local currency exposures in Indonesia and Thailand. In Indonesia, we were driven by changes in the policy setup—including the renewed monetary policy concerns, as the central bank continues to finance fiscal expansion via bond purchases. We also think there may be additional risks associated with Evergrande's impact on the Chinese renminbi and regional currencies. These factors worsened Indonesia's policy and technical test scores. China contagion concerns also featured prominently in our decision to reduce local exposure in Thailand (we swapped some of the proceeds into safer quasi-sovereign exposure).

- Finally, we also reduced local currency exposure in Chile, South Africa and Romania. Chile's domestic political scene is very noisy. The country is facing both the general and presidential elections, with the increasing risk of more populist policies going into the election and after them. The economy is overheating, but the government appears to be willing to stimulate more. This means that the central bank will have to hike more aggressively—which is not the best setup against the backdrop of local valuations that are no longer attractive. In terms of our investment process, this worsened the policy and technical test scores for the country. In South Africa, fiscal concerns are multiplying, as we used a rally to reduce our position and swap part of it into sovereign and quasi-sovereign exposure (similar to Brazil, South Africa's external position is very good, the central bank's non-intervention policy means there is no pressure on the reserves). As regards Romania, we took partial profits after some unexpected developments on the local political scene, which worsened the prospects of fiscal consolidation and reforms (and the policy test score for the country). Our decision was made easier by the fact that local bond valuations—and the technical test scores—are no longer compelling (initial valuation bucket #3).

Average Annual Total Returns (%)

As of September 30, 2021	1 Month†	3 Month†	YTD	1 Year	5 Year	Life
Class A: NAV (Inception 7/9/12)	-2.72	-2.81	-2.68	5.32	4.70	2.54
Class A: Maximum 5.75% Load	-8.32	-8.40	-8.28	-0.73	3.47	1.88
Class I: NAV (Inception 7/9/12)	-2.66	-2.70	-2.41	5.59	5.01	2.84
50 GBI-EM GD / 50% EMBI GD	-2.75	-1.90	-3.87	3.53	3.03	2.67

As of June 30, 2021	1 Month†	3 Month†	YTD	1 Year	5 Year	Life
Class A: NAV (Inception 7/9/12)	-0.72	3.91	0.14	14.25	5.44	2.94
Class A: Maximum 5.75% Load	-6.43	-2.06	-5.62	7.68	4.19	2.26
Class I: NAV (Inception 7/9/12)	-0.69	3.94	0.29	14.41	5.73	3.23
50 GBI-EM GD / 50% EMBI GD	-0.24	3.81	-2.01	7.09	4.11	2.97

† Monthly returns are not annualized.

Expenses: Class A: Gross 2.30%; Net 1.25%. Expenses are capped contractually until 05/01/22 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.

Source: VanEck, Bloomberg.

Prior to May 1, 2020, the Fund was known as the VanEck Unconstrained Emerging Markets Bond Fund.

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 mea- sure 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 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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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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