VanEck®

EM Debt: Treasuries Turn?

By Eric Fine, Portfolio Manager

VanEck Emerging Markets Bond Fund

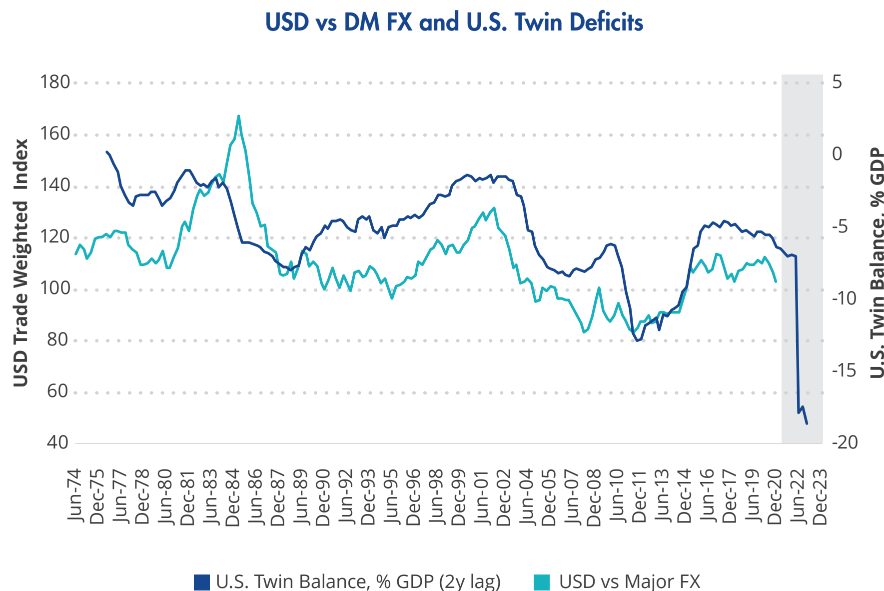
EMBAX / EMBUX / EMBYX

Market Review

The Fund (Class A shares) was down 2.13% in March, in line with its benchmark, which was down 2.02%. YTD/QTD, the Fund was down 3.64%, outperforming its benchmark by 196 bps. Our performance was driven mainly by outperformance vs the benchmark in Brazil and Russia, where owning none continued to be a winner and some underperformance from our overweight in Turkey, which we have since closed.

U.S. Treasuries still drove markets (the U.S. 10-year sold off by over 30 bps). But, importantly, EM local currency outperformed EM hard currency debt (down around 1% and 3%, respectively). This hints that the local currency market has already absorbed a lot this year's move in U.S. Treasuries. Investors went into 2021 expecting an EM debt, and especially EM local currency debt, rally. It didn't happen in the first quarter: "Boo hoo". What did happen is that EM debt went down—but, it went down almost precisely in line with the U.S. Treasury selloff. Credit spreads barely rose and EM currencies—other than Brazil and now Turkey—barely budged. In our framing, nothing has happened in the first quarter other than a Treasury selloff due to improving economic conditions.

Exhibit – USD Historically Hurt by U.S. "Twin Deficits*"



Source: VanEck Research; Bloomberg LP. Data as at December 31, 2020.

If U.S. Treasuries are pausing or reversing, it's a big deal for EM debt. First, it means that carry is back—sideways is obviously a winning scenario for higher-yielding EM debt. Second, interest rates rose due to higher U.S. growth prospects—this is bullish for EM debt fundamentals and thus means lower credit spreads and stronger currencies. Higher U.S. growth increases imports from EM, boosting commodity prices and improves financing conditions. EM debt (the benchmarks) carries at around 5% and we've shown in earlier pieces how this has historically translated into outperformance of higher-yielding debt in rising rate environments.

EMFX looks set up to potentially benefit from global reflation, as rising yields are being generated by "risk-on" economic conditions, not "taper tantrum" conditions, in our view. Commodity prices look set to continue their rise, consistent with our positioning. Note that U.S. front-end rates remain anchored—the 2-year yield barely rose in March. This should be negative for the USD. To reiterate—once the market has digested the "perhaps-stalling" Treasury selloff, the sharply improving global growth outlook should support EM debt. The magnitude of the U.S. expansion should not be underestimated, and it can have a dramatic adverse impact on the USD, as shown in the Exhibit below. The expansion impact is illustrated by the U.S. "twin deficits" or the fiscal and current account deficits.

We remain very attracted to EMFX, but we are no longer very averse to duration. U.S. rates have likely completed over half of what they'll do in 2021 and the market could grind sideways for months, until the next big economic development starts driving markets (we reckon it will be the Infrastructure Bill in the U.S. in 2H2021). If the U.S. 10-year Treasury is returning to its pre-Covid yield of 2.75% (in the middle of its 2.5%-3.0% range), then we have another 100 bps to go from the current level of around 1.73%. But, the 10-year was at 0.5% just in the second half of 2020, and was at 0.9% at the end of 2020. This means that the 10-year has already sold 125 bps off of its low and 83 bps YTD—a lot has happened already! In addition, remember that YTD spreads didn't widen significantly and EMFX was fine if you excluded big losers like Brazil and Turkey.

The Fund has duration of 5.8 and carry of 5.6%, with approximately 60% of our exposure still in local currency. We think that when the Treasury selloff stops, the rally in many risky assets related to the USD could be sharp and swift. Note that our duration is higher for the first time since December. We continue to like our local currency exposure, due to the generally positive global backdrop combined with a number of EM local currency bonds that pay high real yields and, we believe, will see improving fundamentals as a result of this backdrop. While EM local currency may not reflect improved growth prospects, duration and yield may already reflect them. The local currency EM debt benchmark is down YTD by approximately 1% more than the hard currency benchmark. But, it was stabilizing in March, and is still largely down due to weak outliers like Brazil and Turkey. (Not owning Brazil local currency in our fund has been a huge contributor to our outperformance. In addition, Turkey's size was limited, even though it was an overweight position and it was not a long-lived view.)

Our "benchmark-in-line" performance in March was balanced by outperformance from Brazil and Russia (not owning their local currency helped especially) and underperformance from Turkey, where we had overweight exposure. We based this on our expectation of another 3-6 months of central bank hawkishness, which was undermined by President Erdogan's recent replacement of the hawkish central bank head. We have since closed our exposure to Turkey, because we believe there's serious risk of capital controls under the current policy path. Please find more details on these and other significant exposures below.

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions in March were: China, Mexico, South Africa, Colombia and Indonesia:

- We increased our hard currency sovereign exposures in El Salvador and Ecuador. In El Salvador, President Nayib Bukele's party won a supermajority in the legislature. As a result, the Ministry of Finance is now able to confirm that the government will pursue a 3-year EFF (Extended Fund Facility) program with the IMF. In terms of our investment process, this improved the country's policy test score. The initial reasons for having exposure in Ecuador still hold—the bonds are cheap to fundamentals and debt is now almost non-existent after the restructuring (U.S. buying China's debt). We still had some room to add after our first allocation back in January and since both the policy and the technical test scores for the country looked good, we made the move last month.
- We further increased our local currency exposure in Chile and Colombia. In Colombia, the currency still looks cheap to oil and short-term bonds look cheap to fundamentals. The bonds are also likely to benefit from one of the calmest inflation outlooks in the region. We expect to see a wider fiscal deficit for 2021, but Colombia's unprecedented access to the IMF Flexible Credit Line should help with the 2021 financing needs. In terms of our investment process, this improves the country's technical (valuation) and economic test scores. The Chilean economy should continue to benefit from an improved outlook

for copper exports on the back of a stronger global growth outlook and "green" policies both in EM and developed markets. At the same time, inflation remains low and we expect that the forthcoming referendum on the new constitution will have a constructive and peaceful outcome. In terms of our investment process, this strengthens the policy and technical (correlation) test scores for the country.

- Finally, we further increased our local currency exposure in the Czech Republic and hard currency sovereign exposure in Qatar. In the Czech Republic, the recent selloff in U.S. Treasuries pushed local bonds to a higher valuation bucket (#1). The central bank remains reasonably hawkish—a good signal for the currency—while another COVID-19 wave had already been priced in. This improves the policy and technical test scores for the country. As regards Qatar, we were mostly attracted by improved valuations (bucket #1 initial allocation) against the improved geopolitical backdrop in the region. In terms of our investment process, this translates into stronger policy and technical test scores for the country.
- We reduced our local currency exposures in Russia and Turkey. In Russia, the sanctions risks might prove stronger than expected—there is definitely more pressure from the U.S. (election interference) and there is potentially more coordination with the EU on this matter. In addition, there are a lot of "sanction hawks" among the newly appointed members of the Biden administration. These factors worsen the country's policy test score. In Turkey, the shocking removal of the orthodox governor of the central bank reversed the policy U-turn, bringing back old concerns about macroeconomic imbalances and worsening the policy and economic test scores for the country.
- We also reduced hard currency corporate exposures in Vietnam and Burkina Faso. In Vietnam, we sold a corporate which became too expensive—and this means the worsening technical test score—in order to free up space for more attractive opportunities. Less compelling valuations were the key reason for reducing our Burkina Faso position as well.

Fund Performance

The VanEck Emerging Markets Bond Fund (Class A shares excluding sales charge) lost 2.13% in March compared to a loss of 2.02% 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 winner was Dominican Republic. Its biggest losers were Turkey, Poland, and Thailand. The EMBI's biggest winners were Sri Lanka, Iraq, and Oman. Its losers were Turkey, Russia, and Egypt.

Average Annual Total Returns (%) as of March 31, 2021

	1 Mo†	3 Mo†	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	-2.13	-3.64	-3.64	34.23	5.17	2.57
Class A: Maximum 5.75% Load	-7.76	-9.18	-9.18	26.51	3.94	1.88
50 GBI-EM GD / 50% EMBI GD	-2.02	-5.60	-5.60	14.57	4.13	2.61

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

	1 Mo†	3 Mo†	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	3.32	8.22	11.41	11.41	6.82	3.10
Class A: Maximum 5.75% Load	-2.62	2.00	5.00	5.00	5.57	2.38
50 GBI-EM GD / 50% EMBI GD	2.69	7.70	4.04	4.04	6.97	3.39

† Monthly returns are not annualized.

Expenses: Class A: Gross 2.69%; Net 1.26%. Expenses are capped contractually until 05/01/21 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.

*Twin deficits refer to a country's fiscal and current account deficits. A fiscal deficit is a budget shortfall, while a current account deficit means a country is sending more money overseas for goods and services than it is receiving.

Source: VanEck, Bloomberg.

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

Value at risk (VaR) is a statistic that measures and quantifies the level of financial risk within a firm, portfolio or position over a specific time frame. Beta is a measure of the volatility–or systematic risk–of a security or portfolio compared to the market as a whole. Correlation a statistic that measures the degree to which two securities move in relation to each other.

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.

Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The Index is used with permission. The index may not be copied, used or distributed without J.P. Morgan's written approval. Copyright 2020, J.P. Morgan Chase & Co. All rights reserved.

Please note that the information herein represents the opinion of the portfolio manager and these opinions may change at any time and from time to time and portfolio managers of other investment strategies may take an opposite opinion than those stated herein. Not intended to be a forecast of future events, a guarantee of future results or investment advice. Current market conditions may not continue. Non-VanEck proprietary information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission of Van Eck Securities Corporation

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.

©VanEck.

Van Eck Securities Corporation, Distributor
666 Third Avenue | New York, NY 10017
vaneck.com | 800.826.2333