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Gale Force Uncertainty Creates EM Debt Tailwinds

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VanEck Emerging Markets Bond Fund

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

Overview

In January, the Fund returned 5.02%, compared to 3.73% 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 129 bps. We are continuously monitoring the market and proactively positioning our portfolio to address changes in the market environment. We completed our months long duration reduction from 8-handle to 4-handle by lowering exposure to investment grade bonds. We also trimmed our EM Asia currency exposure but would likely re-enter at an attractive valuation driven entry point. The Fund has benefitted from our duration reduction in investment grade securities. As of end-January, local currency exposure was 49.68%, duration was 6.63 and carry was 7.26%.

All key global macroeconomic drivers are maximally uncertain – rates, FX, duration, IG spreads, growth and inflation. Starting with the driver-de-jour, U.S. 10-year rates could go up or down 50bp easily…hey, they might be doing it (the up by 50bp part) right now! And we're going to intentionally skip over the inflation story because that topic is divided into inflation versus commodities (which we've written about) and inflation versus labor (among other basic conflicts), our point being that it is characterized by great uncertainty. We are not going to pound the table on a U.S. inflation view, instead our stance is to insulate our portfolio from possible risks. The most important example of how we're reacting to such risk (if we're correct in seeing it) is noting its incompatibility with near-record-low IG spreads.

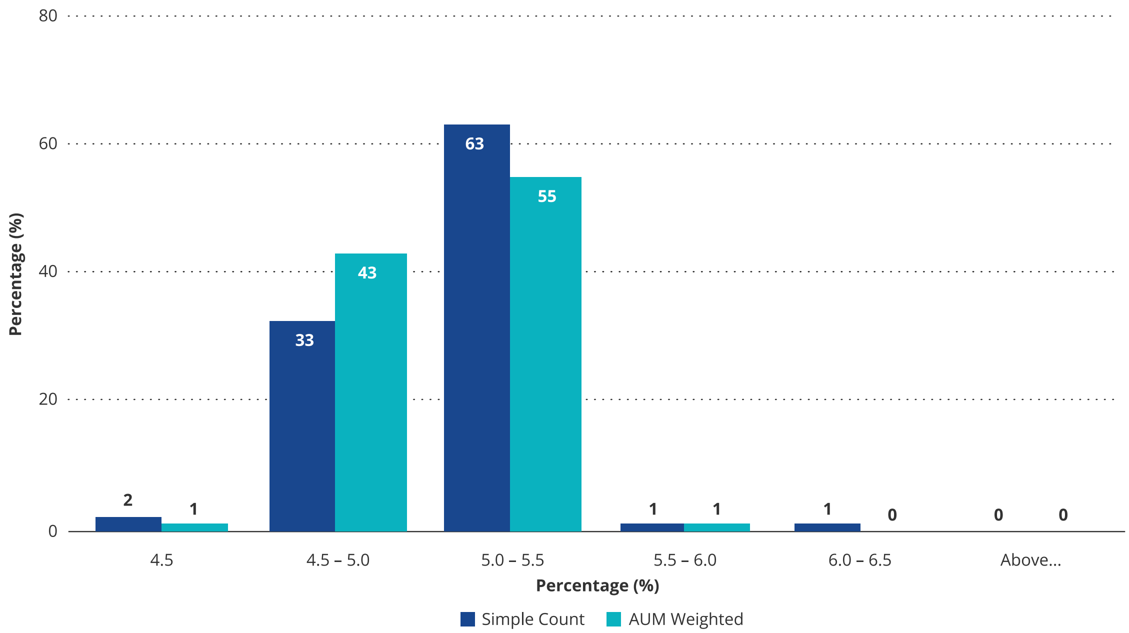
Exhibit 1 – Near Record Low EM IG Spreads (Sovereign and Corporate) Minus U.S. IG Spreads

US IG represented by J.P. Morgan Global Aggregate IG North America Index
Source: Bloomberg LP. As of 31 December 2022
Past performance is not indicative of future results. Please see important index descriptions and disclosures at the end of this commentary.

And just to beat the rates discussion to death – here's a good one. We don't know how the U.S. Federal Reserve (Fed) measures financial conditions. The metrics they told us they looked at, the financial conditions index (FCI), are now different. The real policy rate is the 'thing' now, maybe. Don't ask whether you use trailing n-month, or forecast inflation, or contemporaneous inflation, I guess we'll find out? Anyway, with breakevens where they are, the real rate is very positive at the 2-year (and other) points on the yield curve, so that rightly counts as tight. And, it may be! Our point is that we are trying to insulate our portfolio from these uncertainties and basic debates, not base a portfolio on our opinions on them.

Our months-long duration reduction from 8-handle in October 2022 to 4-handle currently, is completed. IG spreads tightened along with the nominal 10y U.S. yield, and we weren't concerned about risk-free rate rises because the spread cushion was substantial. In the extreme high-quality cases, we're talking Saudi Arabia, Kuwait, UAE, but also strong USD creditors Mexico, Peru and sometimes Brazil. We happened to see a big risk of 10y rates declining back in October, but most importantly we were insulated from being wrong on that view by wide credit spreads (which was awesome, because they absorbed the inevitable volatility of U.S. 10y yields even as they declined). Anyway, the cushion's not there anymore, so we're looking to make our beds elsewhere than IG. Oh, and major bonus! Check out what the survey says on rates expectations (over $1tn in emerging markets (EM) Debt Manager AUM represented in this survey). Nobody sees the terminal rate higher than 5.50-6.00! That result is astounding! Nobody…and yet the risk of higher is a 'thing' just via observation (i.e., reading newspapers). I mean, you don't need to be a trader to be crazy wary of this technical setup. Seatbelts on.

Exhibit 2 – Nobody Fears the Reaper!



Simple count is the count based on the investor. 20 investors out of 100 is 20. AUM weighted is the weight based on the investor's AUM. 20 investors with 40 percent of the AUM counts as 40.
Source: J.P. Morgan February 2023.
The projections, opinions, forecasts and other forward looking statements contained herein do not reflect actual results.

And a simple listicle will suffice to round out this picture of great uncertainty for all key global macroeconomic drivers of asset prices. Some are observations and don't merit prose explanations:

Listicle of Uncertainty in Every Important Thing

1. **U.S. Rates** — The turn in rates is viewed as the turn in risk. It is not. And that's just the market having it upside-down. The Fed is changing its metric for financial conditions in the middle of a hiking cycle, to one that shows policy is tight, not loose. Talk about uncertainty. Oh, and it all depends on the labor market and commodities; great that those sectors are so crystal-clear to analyze.

2. **Bank of Japan's Yield Curve Control (BoJ YCC)** — is it releasing pressure on yields as they go higher…or is it flooding the market with yen liquidity as they are defending the yield, resulting in leakages/JPY lower? This might push yields higher…lather-rinse-repeat. We don't know. Big uncertainty.

3. **Euro** — Is it the same old euro of every crisis generating new ECB tools to federalize sovereign debt (and banks and national fiscus), or is the energy and geopolitical challenge an unpriced new state-of-nature? We have opinions on this, actually (see below), but the key is not our opinion, the key is the limited upside (whether nominal yields or other valuation approaches) from a lot of European assets. (Our portfolio is obviously curated, so we'll be biased toward the superior risk/return assets within Europe, which is intended to get around this risk).

4. **Global Growth** — Is the U.S. recession that the yield curve is pricing the 'thing', or is it China's re-opening? We don't know. Luckily, EM debt is filled with opportunities geared toward China reopening. *Risk for thee, not for me.*

5. **Revenues vs Earnings** — I mean, if inflation and growth are subject to great uncertainty, so are revenues and earnings. You don't get more central than that, and there's risk of bad news on *both* metrics.

6. **Geopolitics are good for EM, even if you don't like why or how it's happening** — Do we even need to write an explanation? The West breaking key strategic guidelines established by Henry Kissinger and Zbigniew Brzezinksi may find out why those guardrails existed (really complicated concepts like…don't let Russia and China and Iran marry). The rules were there to protect our interests, but different priorities are driving Western policy now. The result is that all the territory between Russia, China and Iran is gone to the west, and we can't play anyone against anyone else anymore. Whether it is "worth it" from a U.S. strategic perspective is irrelevant to us, we're just EM debt analysts making predictions and trying not to be subject to risks from U.S. strategic decisions (for example, we were the only fund that did not own Russia or Ukraine bonds going into the invasion). Kazakhstan alone provides 40% of global uranium. All Russian pipes are being built eastward, completion 2025. A shutdown of Hormuz (Iran) is not $100 oil, it is $100s oil. Did you hear the one about the end of the petrodollar? I hope so – China and India can now pay Gulf countries for oil in yuan renminbi (CNY) and rupees (INR). What do you think those countries will do with that cash? They have to buy CNY and INR bonds (those particular bonds are 'yours', in our opinion, but there are plenty of better-curated EM currencies subject to the same dynamic).

None of these geopolitical developments are, when you view them this way, negative for EM. They are all positive for EM, it's just that it may be due to developed markets (DM) countries needing to face inward to address problems, which is never fun when you're in one of those countries. Luckily, EM can access these opportunities – commodity-price upside risk is positive for our positions (and big chunks of EM debt in local and hard currency). It's one of our themes – the commodities headwind for DM is a tailwind for EM. Come aboard! That's the beauty of the end of the petrodollar if you have access to EM – a headwind for DM, a tailwind for EM. Come aboard!

Exposure Types And Significant Changes

The changes to our top positions are summarized below. Our largest positions in January were Indonesia, Malaysia, Colombia, Thailand and South Africa.

- We increased our local currency exposure in Romania, Hungary, the Czech Republic and Israel. EM disinflation is bumpy – and Central Europe is not an exception – but moderating energy and food prices, as well as the high base effect, will make sure that price pressures will continue to moderate in the coming months. In addition, the end of the hiking cycles, lower energy prices, and China's rebound also suggest that the growth outlook for Central Europe might not be as dire as previously feared. In terms of our investment process, this improved the technical and economic test scores for Poland, Hungary and the Czech Republic. As regards Romania, an additional supporting factor is an absence of policy disputes with the European Union, which ensures that EU grants continue to flow uninterrupted. Romania is also self-sufficient – an extra bonus for the country's policy and economic test scores. In Israel, we point to such supporting factors as very attractive valuations, strong external accounts and a credible central bank – or stronger economic, policy and economic test scores (using our investment process's terminology).

- We also increased local currency and hard currency sovereign exposure in South Africa and hard currency quasi-sovereign exposure in Colombia. In Colombia, we added longer-dated (~10y) bonds to express the global duration theme, as global disinflation continues and tightening cycles are coming to an end (including Colombia), improving the technical test score for the country. The South African policy/politics test score looks much better now, as the noise associated with the soft coup against the president and the ANC conference messages is subsiding. The super-credible central bank is – as usual – an added bonus.

- Finally, we increased hard currency sovereign exposure in Pakistan and Senegal, and hard currency sovereign and corporate exposure in Nigeria. In Senegal we were attracted by cheaper valuations (against the backdrop of a decent policy backdrop), which improved the technical test score for the country. Pakistan avoided a hard default, and is currently trading rich relative to peers – so, the technical and policy test scores look better. But the situation should be monitored very carefully. In Nigeria, we started to position for the presidential elections – and a good chance of a new administration, which should result in a better policy framework, improving the respective test score for the country.

- We reduced our hard currency quasi-sovereign and corporate exposure in China, taking profits on positions that rallied the most since re-opening, and the new real estate policy support. In terms of our investment process, the technical test score for these positions has deteriorated.

- We also reduced our local currency exposure in Brazil and Mexico, and hard currency sovereign exposure in Mexico and Peru. Our main concern in Brazil is the uncertainty about the policy direction (especially on the fiscal front). The January riots might have strengthened President Luiz Inácio Lula da Silva's (Lula's) stronger political standing, and this can make it easier to push for the populist agenda. President Lula's obsession with the central bank's independence also sends a negative signal, worsening the policy test score for the country. Mexico's valuations are getting really stretched, with the market narrative switching from Mexico to China. In terms of our investment process, this worsened the technical test score for the country. In Peru, we reduced our long duration exposure due to concerns about correlations with U.S. Treasuries, as the market might be getting too optimistic on the disinflation progress and the pace of rate cuts in the U.S.

- Finally, we reduced our hard currency sovereign exposure in the United Arab Emirates, Saudi Arabia and Qatar. The reasons were very similar to our reasoning in Peru – correlation with longer-dated U.S. Treasuries and the market's getting too excited about policy easing in the U.S. In terms of our investment process, this worsened the countries' technical test scores.

Average Annual Total Returns (%)

As of January 31, 2023	1 Month†	3 Month†	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 7/9/12)	5.02	18.84	5.02	-1.73	0.78	1.34	0.43
Class A: Maximum 5.75% Load	-1.01	12.01	-1.01	-7.38	-1.19	0.15	-0.16
Class I: NAV (Inception 7/9/12)	4.78	18.73	4.78	-1.48	1.09	1.63	0.72
50 GBI-EM GD / 50% EMBI GD	3.73	12.75	3.73	-10.26	-4.52	-1.56	0.22

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

† 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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The "Net Asset Value" (NAV) of a Fund is determined at the close of each business day, and represents the dollar value of one share of the fund; it is calculated by taking the total assets of the fund, subtracting total liabilities, and dividing by the total number of shares outstanding. The NAV is not necessarily the same as the ETF's intraday trading value. Investors should not expect to buy or sell shares at NAV.

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.

A **handle** is the whole number part of a price quote, that is, the portion of the quote to the left of the decimal point.

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