

# EM Debt: All About Treasuries...For Now

By Eric Fine, Portfolio Manager

## VanEck Emerging Markets Bond Fund

EMBAX / EMBUX / EMBYX

### Market Review

The Fund (Class A shares) was down 0.80% in February, with 181 bps of outperformance relative to its 50/50 benchmark made up of the GBI-EM and EMBI indices, which was down 2.61%. Year-to-date, the Fund is down 1.54%, with 212 bps of outperformance relative to its benchmark. In February, we outperformed due to low exposure to Brazil and high exposure to Mexico (Pemex, in particular), Ecuador and Ghana were also sources of outperformance. The U.S. Treasury sell-off drove emerging markets ("EM") debt in February, along with all global asset prices. EM local currency and hard currency both weakened by similar amounts. As a result, our outperformance seems to be based on country-specific factors and our low duration.

We think that the rise in U.S. interest rates is bullish for EM. Once the market has digested the still-ongoing Treasury selloff, we believe the sharply improving global growth outlook should support EM debt. Our core view is that U.S. interest rates are rising due to stimulus and what we view as sharply improving U.S. growth prospects. This increases imports from EM and potentially boosts commodity prices, in particular.

Note that U.S. front-end rates are anchored and slightly lower during this period of rising U.S. yields and a steeper yield curve. Higher long-term rates reflect higher long-term growth prospects. Anchored rate hike expectations—now out to two years—reflect a dovish Fed. This should be negative for the USD. To reiterate—once the market has digested the still-ongoing Treasury selloff, we believe the sharply improving global growth outlook should support EM debt.

Our key asset price views remain intact—we are attracted to emerging markets foreign currencies ("EMFX") and averse to duration. U.S. rates look set to continue rising, making duration a big risk, especially for "safe" investment-grade bonds. Having low duration helped us a good amount in February, and we expect it

to help in March, too. But, that will change as the Treasury selloff peaks. We would reckon that the 30-year goes to 3%—a perhaps painful-for-markets move. Still, if that is the right level, we are more than half way there.

EMFX looks set to benefit from global deflation, 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. Commodity price strength has basically been the standout among risk assets. This is directly bullish for EM commodity exporters and a reflection of bullishness in the more Asia-heavy commodity importers. Oil is strong, reflecting supply constraints and final demand, and metals (copper especially) reflect final demand and ESG considerations. These have an impact on specific EM countries, many of which we favor. There are even hybrids, as an example of the above phenomena—Malaysia is the only net beneficiary in the region from higher oil prices, but it is also one of the world's leading auto-chip makers.

What are our key asset price views for 2021 after our first month? Pretty much unchanged. EMFX-attraction and duration-aversion, to put it simply. U.S. rates look set to rise, making duration a big risk, especially for "safe" investment-grade bonds. EMFX looks set to benefit from global deflation, 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. We like China for reasons explained in previous monthlies. What we would add is that, if the authorities challenge currency weakness, the bonds themselves may rally—they offer among the highest real yields in EM. Indonesia is a reform stalwart with high real yields in a neighborhood with none. In our view, Russia has never had better fundamentals and we see sanctions risks as priced. South Africa is hated and has an improving current account and the prospect of near-term growth.

We have even added Turkey in local currency, as hinted at in our last monthly, to our Turkish U.S. dollar-denominated bonds. Its real policy rate is the highest in the EM world and it looks as if policy has been made orthodox for a short period of time. The market seems very underweight there, too, to our sense.

There are numerous fundamental drivers underlying our views and positioning. First, U.S. fiscal stimulus looks likelier following Democrat control of the Senate. Related, stimulus should continue to generate even bigger current account deficits, which generally help EM economies. Too many market participants, in our view, are translating their aversion to President Joe Biden's new policies to negativity about markets, whereas we simply see likelier stimulus that puts greater upward pressure on U.S. fiscal and current accounts which are bullish for EM. Second, Chinese currency strength translates into global inflation. Third, higher oil and other commodity prices should further boost inflation and EM fundamentals. It does not look like U.S. rate rises will be viewed as a challenge to the Fed, which seems willing to accept them for now. If we do get to the point of yield curve control ("YCC"—as implemented in Japan), that will be a big moment in history. It will be the moment the Fed truly realizes it is simply an organ of the government and cannot bankrupt it with high interest payments. That could be a very U.S. dollar-negative moment, in our view, and perhaps very positive for "risk" assets. However, we lay that out to be chewed on as we watch the current, more straightforward, rise in yields play out.

G-10 rates have been highly correlated and the rise in U.S. rates should be mirrored in other "risk-free" bond markets.\* If so, this means that we will not simply see higher U.S. rates, which by themselves could be bullish for the U.S. dollar. Also, our longstanding view remains that if rates are rising due to greater final demand, this tends to be positive for risky assets such as equities and EMFX. It is difficult to find serious inflation pressures in EM and we tend to own bonds with high real interest rates. Also, EM tends to export the things that are creating inflation (food and energy), which means their external accounts (and currencies) should potentially be supported. Inflation should ultimately be the result of policy, not these one-off price rises, in EM economies, as EM central banks tend to be orthodox. Unlike developed markets ("DM") central banks, their modus operandi is not to gin up asset prices, but to focus on general price stability and leave the other

work to the fiscal/political authority, which has responded with steady structural reform (also unlike the never-ending "free stuff" attitude of the DMs).

So far in the first weeks of 2021, we have seen higher U.S. rates, higher commodity prices, higher equities, but not yet higher EMFX. We think that EMFX is simply taking a breather, significantly due to overdone concerns about an early taper from the Fed and then overdone concerns about GameStop, in our view. In fact, one could argue that the market's brief obsession with GameStop told us how "themeless" the market was and that it was looking for an excuse to hiccup. Anyway, the trifecta of higher rates, higher commodity prices and a lower USD should maintain in the first quarter of 2021, we believe. EMFX remains below its pre-COVID-19 highs, we should add. Fed Vice Chair Richard Clarida clarified a nascent market concern over tapering at the end of the first week in January, putting that discussion firmly into late 2022, in our view.

We start March with approximately 60% of the Fund in local currency, carry of 5.9% and duration of 5.0. Note that our duration is very curated, with special culling of long duration bonds whose spreads are low as a percentage of their yields. In other words, the duration we have should do well in a reflation. It is "safe" low-yielding bonds that are at great risk, in our opinion.

### Exposure Types and Significant Changes

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

- We increased our local currency exposure in Colombia. We are cautious about duration right now, but Colombia's short-term bonds look cheap and are likely to benefit from one of the calmest inflation outlooks in the region. The currency does not look expensive either and it should do well if oil rallies further. In terms of our investment process, this improved the economic and technical test scores for the country.
- We also increased our local currency exposures in Chile and Malaysia. Chile should be among the key beneficiaries of the improving growth outlook in China and China's "green" revolution, which is likely to boost demand for copper. These secular trends should encourage additional foreign direct investments in Chile, which declined in the past few years.

In terms of our investment process, this improves the country's economic and technical (correlation) test scores. As regards Malaysia, we are correcting a big underweight, as we think the economy stands to benefit from the global chip shortage. In terms of our investment process, this improves the economic test score for the country.

- Finally, we further increased our hard currency corporate exposure in Ghana. We participated in a new issue from Kosmos, a conventional offshore oil producer with assets in Ghana, the U.S. Gulf and Equatorial Guinea, as bonds were priced cheaply (a Bucket 1 in our model). Though the balance sheet weakened due to the pandemic, we viewed favorably management successfully steering the company through a difficult 2020, maintaining liquidity through year end. We also saw its U.S. Gulf assets as a plus within the company's portfolio.
- We reduced our local currency exposure in Indonesia. We believe the central bank's policy space is limited, in part because the government's fiscal stance is very expansionary by Indonesia's standards. If the central bank decides to go for another rate cut, we believe this might turn out to be a policy mistake. In addition, our shorter-term valuation model points to a limited currency upside. In terms of our investment process, this worsened the country's policy and technical test scores.
- We also reduced hard currency sovereign exposure in Sri Lanka and quasi-sovereign exposure in Mexico. In Mexico, we sold a quasi-sovereign bond with very long duration as a reflection of our concerns about rising global rates and the U.S. Federal Reserve's reaction function. In terms of our investment process, this reflected the worsening technical

test score for the country. Sri Lanka's story is more rooted in macro and policies. The catalyst was a decision by India's central bank not to roll over its swap line with Sri Lanka. This happened against the backdrop of Sri Lanka's huge financing needs and was a clear negative development compared to our base-case scenario just months ago. In terms of our investment process, this worsened the country's economic test score.

- Finally, we reduced our hard currency sovereign exposure in Armenia, Paraguay and Maldives. A big uptick in Armenia's political noise on the back of mass protests was our main concern there, as it worsened the policy test score for the country. Our decision to exit our exposure in Paraguay reflected less compelling valuations and hence the worsening technical test score. As regards Maldives, the country may easily get affected by the latest developments on the debt relief front for poorer countries. The G20 initiative calls for obligatory consultations with private debt holders and at least one country—Ethiopia—might try to do just that, raising concerns that others might follow suit. In terms of our investment process, this worsened the policy test score for Maldives.

## Fund Performance

The VanEck Emerging Markets Bond Fund (Class A shares excluding sales charge) lost 0.80% in February compared to a loss of 2.61% 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 Mexico, Brazil, and Thailand. The EMBI's biggest winners were Ecuador, Zambia, and El Salvador. Its losers were Peru, Panama, and Indonesia.

### Average Annual Total Returns (%) as of February 28, 2021

	1 Mo <sup>†</sup>	3 Mo <sup>†</sup>	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	-0.80	1.73	-1.54	9.88	6.31	2.85
Class A: Maximum 5.75% Load	-6.50	-4.12	-7.20	3.56	5.06	2.15
50 GBI-EM GD / 50% EMBI GD	-2.61	-1.07	-3.66	2.35	5.81	2.88

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

	1 Mo <sup>†</sup>	3 Mo <sup>†</sup>	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](http://vaneck.com) for performance current to the most recent month ended.

\*Risk free bond markets refers to financially stable countries that offer government bonds which are often treated as risk-free bonds.

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 is 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 another. 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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**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](http://vaneck.com) for performance information current to the most recent month end and for a free prospectus and summary prospectus.**

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666 Third Avenue | New York, NY 10017

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