

# Growth Slowdown vs. Policy Stimulus

By Eric Fine, Portfolio Manager

## VanEck Unconstrained Emerging Markets Bond Fund

EMBAX / EMBCX / EMBUX / EMBYX

### Market Review

The quarter started with a bang and is ending decidedly mixed, at least in our thinking: in January, our commentary title was “Investable Rally.” In February, our title was “Back to the fundamentals”, and our current title is “Growth Slowdown vs. Policy Stimulus.” To recapitulate a bit and set the stage, our view in January was that tailwinds from global macroeconomic forces (a “blinking” U.S. Federal Reserve (Fed), stimulating China, and green growth shoots in EM) were significant tailwinds to EM beta...significant enough to be patient about the growing number of EM problem areas. In February, we reduced some of our riskier EM local currency exposures, expecting a “pause”, as global tailwinds abated and/or got priced in. Dovish Fed talk and Chinese optimism abounded, but markets weakened. Now, in March, we saw much more of a mixed bag, in our opinion, with renewed weakness in crisis-prone Turkey and Argentina, for example, but strength in others. Overall, The market weakened again. This is consistent with a market with winners and losers, rather than one with a broad risk-on/risk-off nature.

We see a “mixed bag” now for a number of reasons: first, the global macroeconomic environment seems to be finely balanced between ongoing economic weakness versus stimulus in the pipeline. One can lament the weak growth or cheer the stimulative policy reactions, making the glass either half full or half empty. The details are these: the U.S. 10-year Treasury rate went from approximately 2.75% to 2.4% in March alone. This follows the collapse in 2-year rates we noted in previous writings. This is “glass half full” stuff. Yet, the EUR bounced between 1.14 and 1.12 and there was no pronounced USD selloff, highlighting the empty part of the glass. In addition, the U.S. 3-month/10-year yield curve points inverted—to much

fanfare. This is also, classically, a half full/half empty moment, with the inversion pointing to recession risks (glass half full), but last month’s Fed comments pointing to a central bank that is already re-evaluating (glass half-empty). Thus the tomes devoted to “curve inversion predicts recession”, as well as “curve inversion not a reliable recession predictor.”

Outside the U.S., German data surprised to the downside (the March manufacturing Purchasing Managers’ Index (PMI) plunged to 44.7), reinforcing a weak growth narrative, but we still saw a range-bound EUR (it could not selloff and break the key 1.12 level, either, in other words). We believe, Europe’s inability to track U.S. and global growth upwards has remained a defining challenge to the “global synchronized growth” story that ended in 2Q2018. The month of March did end with some good growth news from China (the non-manufacturing PMI firmed to 54.8, and the Caixin manufacturing PMI surprised even more to the upside) and a positive reaction from risky assets on the first day of April. But we do not think that the success of China’s stimulus is a game changer. We remain of the view that it is European growth that remains a key roadblock to a more broad-based rally in EM beta. Still a mixed bag, in other words.

We see a “mixed bag” in EM, as well, with Turkey and Argentina risking a return to “crisis mode,” Mexico and South Africa just managing to avoid a downward spiral for now, Thailand and Indonesia stable, and Brazil, and perhaps Ukraine, establishing reform momentum. Turkey remains at great risk, in our view. The most recent developments are consistent with the de-rating view that kept us out of Turkey throughout 2018. The latest example of heterodoxy is that the government suspended its one-week money auctions as a way

of preventing onshore banks' access to liquidity that was being used to buy U.S. dollars (whether by onshore actors, or whether by being on-loan to offshore actors who then bought U.S. dollars). Currency forwards spiked higher (i.e., it became prohibitively more expensive to short), and any USD purchases in the actual spot market that still happened were met by government (technically, a state-owned bank) sales of dollars. (We've explained elsewhere why we thought this reserve decline might happen, and why Turkey doesn't have enough U.S. dollars to be engaging in such a defense of its currency.) We believe, this was all done to keep markets calm going into local elections, which are now concluded. As a result, two things have now been established: a) central bank reserves are even lower; and b) the government has shown that it is willing to entertain capital controls, rather than good policy (like interest rate hikes) to achieve asset-price objectives. The problem with all of this is that most of the current exposure to Turkish local debt markets is long-only (we don't believe there's a big speculative "short"), so these moves by the authorities have only served as a starting gun for an exit. ("Thanks for telling us you are good with capital controls ... we're leaving now ... tell us when you've changed your mind.") As an aside, our advice for policymakers in such situations is: "Don't complain about your lenders unless you plan to stop borrowing."

On to Argentina. We are not Argentina haters, as our Fund's nearly seven years of exposure to the country attests. But we are currently among the only funds to have no exposure there. Here is why. (We've written on Argentina in more detail in our country-specific pieces, so we shall keep the explanation general.) Basically, the country levered up on USD debt, and the currency is weakening due to capital flight and an extreme overweight position from offshore investors. U.S. dollar debt plus currency weakness is the classic "original sin" in emerging markets. In our view, the hope was that growth (higher) and inflation (lower) outcomes would generate a victory for President Mauricio Macri in elections later this year. Growth and inflation have not been fitting this hope.

Some sovereigns are skirting the edge of crisis: Mexico and South Africa. Both are investment grade (IG) rated sovereigns, with risks to their ratings. But, the risks are on a burning fuse which simply has not connected with the gunpowder yet, in our opinion. Moody's decided not to change South Africa's only remaining IG rating of Baa3 on the last business day of March. The agencies are warning on Mexico, which has a full suite of IG ratings currently. Overall, though, policy is so heterodox—and challenged in particular by very tricky-to-control strains on public finances that emanate from state-owned energy companies (Eskom and Pemex)—that, we believe, downgrades are just a matter of time. What is holding it together is unclear, in our view. We would suggest it is the indexation of debt, and the resulting "index-tracking"

investor behavior, plus the "it's cheap to the rating" behavior of U.S. cross-over money. In other words, the same phenomenon that kept Turkey stable for so long ... until it just wasn't. Deputy Portfolio Manager Dave Austerweil just returned from Mexico and issued a report entitled "AMLO Unbound": <https://www.vaneck.com/research-mexico-trip-notes-march-2019.pdf/>

Finally, in the "mixed bag" are obviously some good apples, including Thailand, Indonesia, Brazil, and Ukraine. Thailand and Indonesia appear resilient. Thailand finished elections without big asset price implications, and any economic weakness is boosting its external accounts (consuming less means importing less, while exports power on). Indonesia is facing elections, but the current reformist president looks set to win. Brazil, moreover, is moving forward with pension reform, however noisy. And, Ukraine's elections at the end of March are setting up for a final round between two presidential candidates who are both explicitly in favor of the current International Monetary Fund (IMF) program.

### Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions are currently: Brazil, Indonesia, Colombia, Thailand, and the Czech Republic.

- We increased our hard currency sovereign exposures in Costa Rica and Ghana. In Costa Rica, the market was pricing in a scenario that was too negative, in our view, making the valuations attractive again. In terms of our investment process, this improved the technical test score for the country. Improvements in the technical score—specifically a better value cushion—were also behind our decision to boost exposure in Ghana.
- We also increased our hard currency sovereign exposures in Azerbaijan and Armenia. Both countries have strong fundamentals, with Azerbaijan expected to benefit from a combination of the higher oil prices and the recent policy changes that strengthened the government's fiscal performance (the fiscal rule). In terms of our investment process, this translates into improved technical and policy test scores.
- We also increased hard currency corporate and local exposure in Singapore. On the corporate side, we knew Puma Energy (0.98% of the fund) well (meeting with the management on multiple occasions), the valuation looked compelling (the highest initial allocation bucket in our process). We also liked the diversification argument (the company operates in about

20 countries). On the government bond's side, we liked a combination of solid macro and more attractive valuations, which translate into high technical and economic test scores.

- We reduced local currency exposure in Thailand and Indonesia. The reduction in Thailand reflected the worsening policy score (elections) and concerns about the current account dynamics which were pushing down the country's economic test score. Our main concern in Indonesia was very heavy positioning, which started to affect the country's technical test score.
- We also reduced hard currency sovereign and quasi-sovereign exposure in Argentina. The past month brought no improvements in the country's policy or economic test scores, in our view,—there are multiple concerns about the government's ability to strengthen the growth outlook and fiscal performance, and push down inflation. We believe, all this significantly complicates the outlook for the next presidential elections. This limits upside for the technical test score as there is still plenty of room to reduce long positioning.

- We reduced hard currency sovereign exposure in Uzbekistan. Earlier in March, the IMF released an updated set of Uzbekistan's statistics, which showed that the current account dynamics and a few other credit metrics deteriorated much more than previously thought. In terms of our investment process, this worsened the country's economic and technical (valuations) test scores.

### Fund Performance

The VanEck Unconstrained Emerging Markets Bond Fund (Class A shares excluding sales charge) gained 0.47% in March compared to a gain of 0.05% 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 winners were Peru, Russia, and Mexico. The biggest losers were Brazil, Argentina, and Turkey. The EMBI's biggest winners were Mexico, Peru, and Colombia. The biggest losers were Turkey, Lebanon, and Zambia.

#### Average Annual Total Returns (%) as of March 31, 2019

	1 Mo <sup>†</sup>	3 Mo <sup>†</sup>	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	0.47	5.85	5.85	-3.48	-0.11	1.33
Class A: Maximum 5.75% Load	-5.29	-0.31	-0.31	-9.00	-1.28	0.44
50 GBI-EM GD / 50% EMBI GD	0.05	4.93	4.93	-1.78	2.37	2.37

#### Average Annual Total Returns (%) as of December 31, 2018

	1 Mo <sup>†</sup>	3 Mo <sup>†</sup>	YTD	1 Yr	5 Yr	Life
Class A: NAV (Inception 7/9/12)	0.36	-1.99	-6.39	-6.39	-0.49	0.49
Class A: Maximum 5.75% Load	-5.46	-7.64	-11.81	-11.81	-1.66	-0.42
50 GBI-EM GD / 50% EMBI GD	1.33	0.43	-5.15	-5.15	1.95	1.70

<sup>†</sup>Monthly returns are not annualized.

**Expenses:** Class A: Gross 1.71%; Net 1.26%. Expenses are capped contractually until 05/01/19 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.

R-Squared is the percentage of a fund's movements that can be explained by movements in a benchmark index.  
DXY is the U.S. Dollar Index that measures the value of the United States Dollar relative to a basket of foreign currencies.

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 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.

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



Van Eck Securities Corporation, Distributor  
666 Third Avenue | New York, NY 10017  
[vaneck.com](http://vaneck.com) | 800.826.2333