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Debt Rattle for Developed Markets, Birth for Emerging Markets

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VanEck Emerging Markets Bond Fund

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

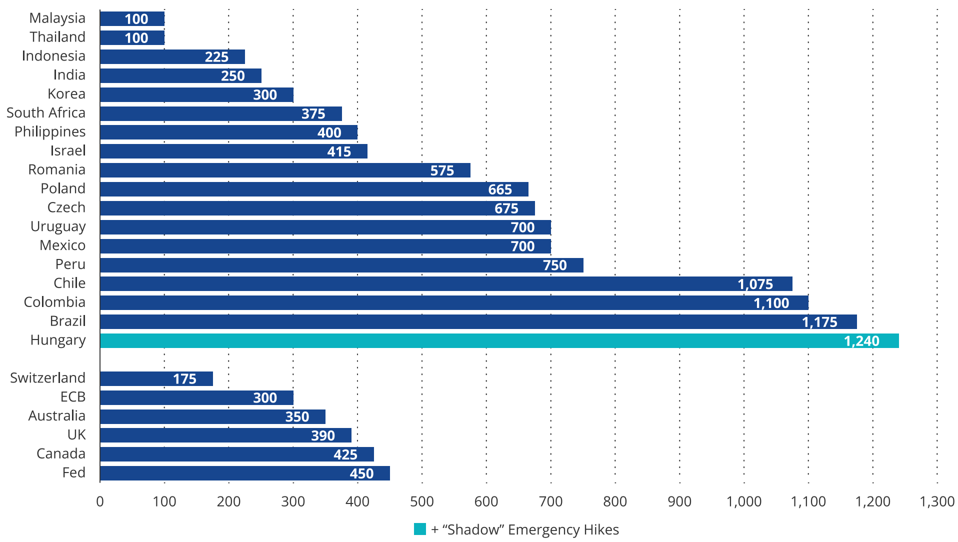
Overview

In February, the VanEck Emerging Markets Bond Fund (the Fund) returned -2.83%, compared to -2.69% 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 underperformance of 14 basis points (bps). Year-to-Date (YTD), the Fund returned 2.05%, compared to 0.95% for its benchmark, resulting in outperformance of 111 bps. We have completed our months-long duration reduction from 8-handle to 4-handle, mostly via reductions in Investment Grade (IG). We also trimmed our overweights in Asian EMFX due to their dramatic repricing, but are looking to reload. We had little high-beta EMFX, such as Brazil and South Africa, but are increasing exposure into their selloffs. As of end-February, local currency exposure was 52.88%, duration was 5.85 and carry was 7.48%. Cash has been a rare high at 5.3%, in anticipation of volatility and buying opportunities.

Why should a central bank buy treasuries, German bunds or Japanese Government Bonds (JGBs)? Don't ask us. For sure, USD (and EUR and JPY) will remain the name of the ongoing flow game for many years to come. But emerging markets (EM) are already up to their necks in dollars, and more so every month. Every central bank that matters has plenty of dollars and has bought treasuries with them. Good thing rising rates aren't killing those assets (treasuries in dollars, i.e., duration risk) as you slowly run off your treasuries…oops. Central banks will ramp up the escape plan EM bonds.

- Sanctions by the US/Germany/Japan on the Russian central banks' treasuries (and bunds and JGBs) held in reserves.
- These central banks must re-evaluate the status of these reserves now that they are known to be subject to cancellation over political disagreement.
- In this framing, the USD can strengthen against JPY and EUR, simply because it is the last to fall. With most debt in USD and higher-yielding, the demand for USD versus JPY and EUR should win.
- Even just looking at the carry of treasuries compared to EM local-currency bonds, and what that means over the next 12 months, shows high-yielding EM bonds are hard to beat in rising or declining risk-free rate environments. The policy rates of EM vs developed markets (DM) show this, too.

Exhibit 1 – Global Policy Rate Changes – From COVID Min to Post-Pandemic Max, bps

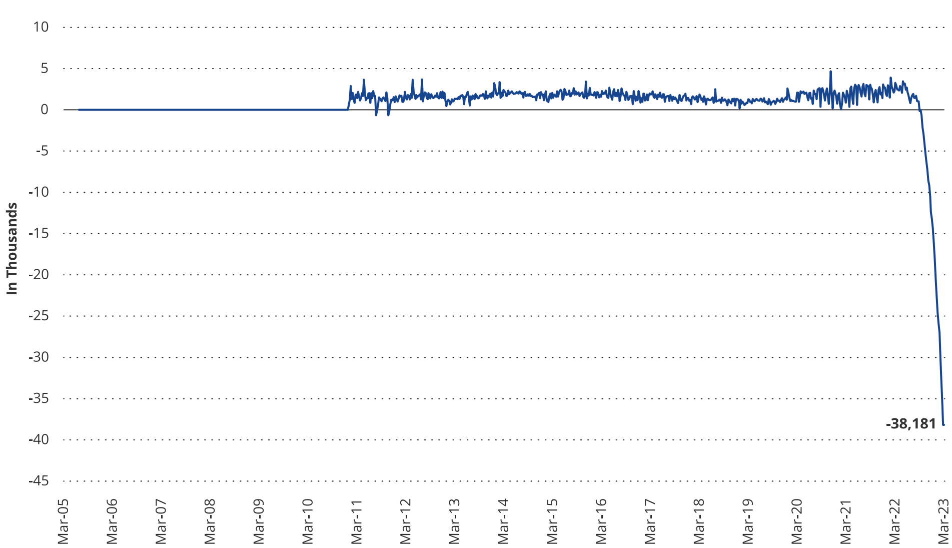


Source: VanEck Research; Bloomberg LP. Data as of March 8, 2023.
Past performance is not indicative of future results. Please see important index descriptions and disclosures at the end of this commentary.

The engineering result is many EM bond markets are now reserve assets; high-local-currency-rated Asian, Gulf and Latin American bonds fit the bill perfectly. China and India (for example) can now (as of last month) pay for Gulf oil with renminbi (CNY) and rupee (INR); this forces those Gulf central banks to use that cash to buy Chinese and Indian bonds. Obviously, in analyzing these developments, you still need to consider central bank independence, carry relative to fundamentals and all the usual properties of bonds that fit a higher or lower status. We don't happen to like the CNY nor INR bonds, but there are tons of great EM bond markets subject to that dynamic. Do developed bond markets still fit this high standard?

- Central bank balance sheets other than these G-3's are reducing their allocation to U.S. treasuries, and increasing their allocations to gold and EM local-currency bonds.
- The balance sheets of central bank balance sheets holding treasuries, bunds and JGBs are large, and these countries are borrowers from EM.
- The balance sheets of central bank balance sheets looking to hold EM local-currency bonds are large and these countries are all creditors to EM.
- Central banks will buy bonds of countries who manage economic affairs similarly to themselves. EM countries with low debts and deficits and high carry will buy local-currency bonds of countries with low debts and deficits and high carry.

Exhibit 2 – Fed Operating Loss



Source: VanEck Research; Bloomberg LP. Data as of March 8, 2023.
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The Fed Operating Loss chart, above, is a depressing chart; let's avert our eyes and play a game! If you are in DM, the game is called Small Pie. If you are in EM, the game is called Big Pie. Play! Terms that define EM, such as "fiscal dominance", are driving markets. What that means is many DMs are facing higher rates and weaker currencies, while a lot of EMs are facing lower rates and stronger currencies.

- "Fiscal dominance" increasingly dominates DM. It is normally created by high levels of debt that mean a country's central bank can no longer increase interest rates (to fight inflation, for example) because doing so would bankrupt the central bank's country.
- Many countries in EM have low debts and deficits and independent central banks, and are thus not subject to fiscal dominance.
- This means that DM countries might see higher rates and weaker currencies no matter what.
- This also means that EM countries might see lower rates and stronger currencies.
- This is precisely what happened from 4Q2022 with Asian EM local currency. These bond markets are the most advanced in terms of economic frameworks of low debt and independent central banks, and this component rallied despite DM bond markets suffering.
- EMs are opening trade and financing structures and using each other's currencies in trade. DMs are sanctioning creditors.

Exhibit 3 – Eurasia is Globalizing/West is De-Globalizing

Exposure Types And Significant Changes

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

- We increased our local currency and hard currency corporate exposure in Brazil. Brazil's local curve looks too "hawkish", given the disinflation progress, albeit we keep an eye on fiscal debates, any downside growth risks that might affect revenue collection and the new administration's stance regarding the central bank's independence. In terms of our investment process, this improves the technical test score for the country. The corporate bond provides a better risk/return profile by not being directly exposed to the policy saga/debate. The bond is also cheap. Although off its mid-2022 lows, it is still in the mid-80s and yields 10.5% for a 2031 amortizing structure (duration of 5.3 years). In early January, the company made a small redemption at USD104 through its cash sweep mechanism, well ahead of its first required payment (Dec 2024). This indicates strong cash flow generation after being taken over by Mubadala in 2022, which we see as a better operator than previous owner Petrobras.
- We also increased local currency exposure in Poland and South Africa. Poland's growth outlook might be less dreary due to lower recession risks in the Eurozone and China's reopening. Poland's policy backdrop is also looking more orthodox – specifically, the central bank is not rushing into rate cuts as inflation is still far away from the target. South Africa is also expected to benefit from China's growth rebound – against the backdrop of moderating inflation. The central bank's policy stance remains cautious and credible, and the 2023 draft budget did not disappoint. These factors improved the technical and policy test scores for both countries.

- Finally, we increased local currency exposure in Peru and hard currency sovereign exposure in the United Arab Emirates (UAE). Peru's political noise obscures the most credible and capable central bank, as well as a fairly stable fiscal outlook (plus, a deep pool of technocrats in the ministry of finance). The country's fundamentals are strong, including moderating price pressures and the narrowing current account gap, while non-resident positioning in local bonds is quite small. In terms of our investment process, this points to stronger economic, policy, and technical test scores. As regards the UAE, respecting our risk limits was made easier by improved valuations (and hence, the stronger technical test score).
- We reduced our hard currency quasi-sovereign and corporate exposure in China and local currency exposure in Malaysia and Thailand. We continued to take profits on our positions in China, which rallied substantially during the initial re-opening rally. The market is clamoring for more evidence that the past policy measures are indeed working – especially in the housing sector – and that the recovery is progressing as expected. Both Malaysia and Thailand are among the countries that are set to benefit markedly from China's growth rebound, so any concerns about China's recovery timeline are bound to have an impact on local assets. We thought it would be prudent to take partial profits, before re-engaging at better price levels.
- We also reduced our hard currency corporate and local currency exposure in Colombia, and local currency exposure in Israel and Hungary. Colombia's policy landscape is getting increasingly convoluted, and this can affect both the inflation and fiscal outlooks, worsening the country's policy test score. In Israel, we decided to take profits after this year's rally due to policy concerns associated with the new cabinet. This worsened the policy test score for the country. In Hungary, we became concerned that inflation might peak at a higher rate, and decided to take partial profits against the backdrop of the worsening economic test scores.
- Finally, we reduced our hard currency sovereign exposure in Kenya and Nigeria, and hard currency corporate exposure in Nigeria and India. Even though Nigeria's presidential elections did not result in a worst-case scenario (the runoff), the winner's mandate looks "thin", while there are a lot of questions about governability and ability to implement much needed reforms. Kenya's valuations no longer look compelling, while the government's decision to resort to an emergency loan from the central bank over a "biting" cash crush is set to worsen the country's debt burden, weakening the policy and economic test scores for the country. Our decision to reduce Indian exposure was due to on-going headline risks generated by a specific company.

Average Annual Total Returns (%)

As of February 28, 2023	1 Month†	3 Month†	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 7/9/12)	-2.83	4.93	2.05	-2.58	0.09	0.89	0.15
Class A: Maximum 5.75% Load	-8.42	-1.10	-3.82	-8.18	-1.87	-0.29	-0.44
Class I: NAV (Inception 7/9/12)	-2.78	4.85	1.87	-2.36	0.35	1.19	0.45
50 GBI-EM GD / 50% EMBI GD	-2.69	2.20	0.95	-7.33	-4.68	-1.80	-0.02

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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Emerging Market securities are subject to greater risks than U.S. domestic investments. These additional risks may include exchange rate fluctuations and exchange controls; less publicly available information; more volatile or less liquid securities markets; and the possibility of arbitrary action by foreign governments, or political, economic or social instability.

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