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EM Debt: Are Investors Looking at the Wrong Risks?

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> Despite profound political risk in developed markets, market participants are still shouting that EM has all the political risk. They're wrong, here's why.

The VanEck Emerging Markets Bond Fund was up 1.65% in May, compared to 1.71% 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). Year to date, the fund has outperformed its benchmark by 60 basis points (bps) (the fund is up 0.12% compared to down 48 bps for the benchmark). During May, the fund increased local currency exposure in Asia (Thailand, Malaysia, Indonesia), and added some China corporate exposure due to China's economic and policy traction. We reduced local currency exposure in Brazil, which is a popular overweight, where the country is beginning an important debate on the role of the central bank. We'll sit that debate out as it is too profound and fraught, especially given bullish positioning. We also increased duration in the fund. We continue to think selected emerging markets currencies (EMFX) will outperform and are tilting toward longer duration as U.S. rate concerns appear over-ripe. Rate cuts will of course support EM local currency. But, we curate and had underweights in Mexico local and now Brazil local (where the market is very long), and are maintaining our overweight in South Africa (where the market is very underweight and developments seem positive). These country-specific stances will be determinant, "EM local vs. hard" will not. That's the way active EM bonds are supposed to be managed, not by providing benchmark exposure. We end May with a carry of 6.8%, yield to worst of 8.8%, duration of 6.1, and around 54.5% of the fund in local currency. Our biggest outright exposures are South Africa (local), Thailand (local), Indonesia (local), China (Hard), and Malaysia (local).

Average Annual Total Returns* (%) as of May 31, 2024

	1 Month	3 Month	YTD
Class A: NAV (Inception 07/09/12)	1.71	0.94	-0.03
Class A: Maximum 5.75% load	-4.14	-4.87	-5.78
Class I: NAV (Inception 07/09/12)	1.65	0.91	0.12
Class Y: NAV (Inception 07/09/12)	1.79	0.99	0.20
50% GBI-EM/50% EMBI	1.71	0.59	-0.48

Average Annual Total Returns* (%) as of March 31, 2024

	1 Month	3 Month	YTD	1 Year
Class A: NAV (Inception 07/09/12)	0.68	-0.29	-0.29	6.76
Class A: Maximum 5.75% load	-5.11	-6.02	-6.02	0.62
Class I: NAV (Inception 07/09/12)	0.76	-0.03	-0.03	7.28
Class Y: NAV (Inception 07/09/12)	0.73	-0.05	-0.05	7.14
50% GBI-EM/50% EMBI	1.03	-0.05	-0.05	8.10

* Returns less than one year are not annualized.

Expenses: Class A: Gross 2.55%, Net 1.22%; Class I: Gross 2.51%, Net 0.87%; Class Y: Gross 2.91%, Net 0.97%. Expenses are capped contractually until 05/01/24 at 1.25% for Class A, 0.95% for Class I, 1.00% for Class Y. Caps excluding acquired fund fees and expenses, interest, trading, dividends, and interest payments of securities sold short, taxes, and extraordinary expenses.

The performance data quoted represents past performance. Past performance is not a guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance may be lower or higher than performance data quoted. Please call 800.826.2333 or visit vaneck.com for performance current to the most recent month ended.

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.

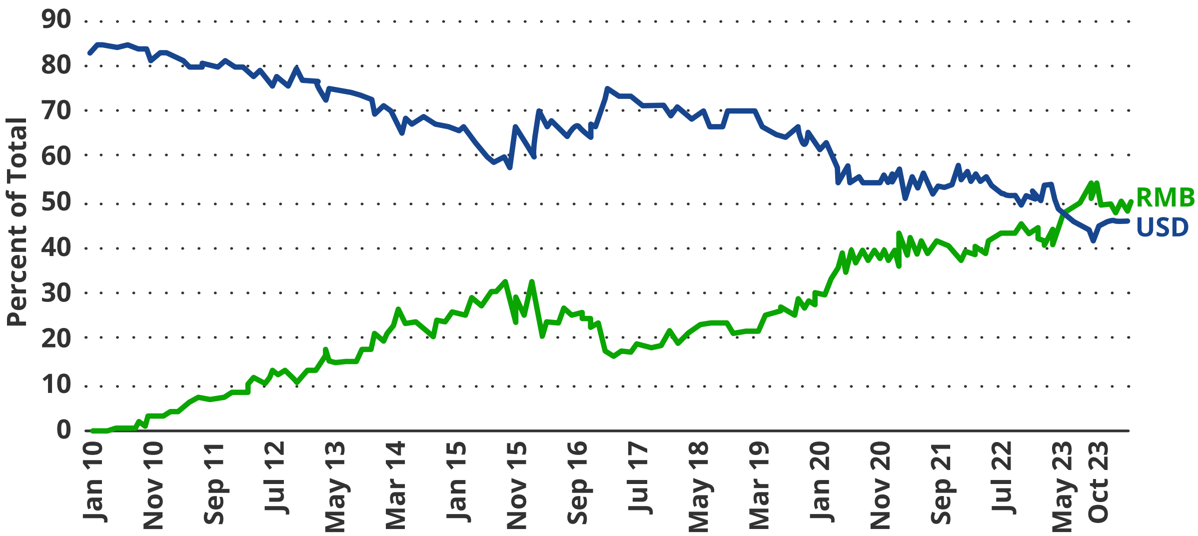
U.S. rates: Get ready for growing recession talk and a rally in duration for which the market is completely unprepared. "High for long" is priced in, but economic weakness is not, so look for the market's latest narrative to implode… soon. Too much of U.S. consumption, and thus growth, has been attenuated by the "wealth effect", making any recession self-reinforcing, to our eye. This topic has to be the most-chewed-upon morsel at the moment, so we're not sure what to say that might be additive or that we haven't said before. We'll just recap our argument. It's our judgment that the following are important drivers of lower policy and market rates for the coming months:

1. Low confidence due to unprecedented U.S. political and policy uncertainty is a significant challenge to economic actors' propensities to consume, save, and invest.
2. Real incomes and wealth are challenged, especially at lower ends of economic wealth (in a political year).
3. Fed reaction functions see high oil prices (or tariffs, even) as reasons to *ease* policy rates (as the higher input costs strain consumers or producers).
4. The market is only publishing "high for long" articles at this point and bond positioning is very cautious on duration, despite roughly 4 cuts having already been priced out this year. 'Nuf said as they say.

Politics: Despite profound political risk in the U.S. and Europe, market participants keep shouting that EM has all the political risk worth focusing on. This is wrong. Mexican, South African, and Indian elections are accepted by all parties, and the near-term implications are mostly for *policy*, not *politics*. This is our day job and we happened to have had a big underweight in Mexico, due to *policy* risk, for example. In particular, our concern was that the Mexican central bank would have more dovish board members (among other risks), while positioning is all bullish. Given Moreno's "super-majority" emanating from the elections, this *policy* risk is now on steroids. But it's not *political* risk. In South Africa, professionals had been watching whether the ruling ANC would fall below 40% of the vote-take, but the initial headlines and focus were on the not-news fact of the ANC losing its 50% majority. That was never in question, the issue was always the ANC's coalition decisions after the election in which they'd lose their majority, and right now a coalition with the market-friendly DA appears likeliest. This would be very positive policy news for South Africa for a market that is underweight, but it is not *political* risk per se. The U.S. and Europe face *both* political and policy risk (which we won't comment on, as popular media are filled with examples).

Geopolitics: Risks are expanding and escalating, maintaining EM-supportive supply risk in commodities. The true conflicts in Europe and the Middle East (or West Asia) are now - NATO v. Russia in Europe and Israel v. Iran v. Turkey in the Middle East (not Ukraine v. Russia, and Israel v. Hamas). Popular media attention will turn to the risks of nuclear conflict, we'd expect, supporting U.S. bond duration. NATO operation and use of longer-range missiles fired into Russia are an obvious risk, and the absence of any dialog between adversaries points to no resolution. Importantly and practically, this means that any "ceasefire" between Ukraine and Russia will be a pause in a bigger conflict. We say this because we could easily see some sort of "ceasefire" and recognition of the actual situation on the ground, (and Ukraine's Zelensky might need to be ousted by his compatriots to allow this to happen). But, this will be a pause in a broadened conflict, at best. Similarly in the Middle East (or West Asia), any pause in the Israel/Hamas conflict must be viewed in the context of the expanding Israel/Iran/Turkey conflict, so don't be lulled if those scenarios happen. Witness recent Israeli strikes on Iranian ally Syria. The theater has expanded, don't get overly excited by any pauses in the drama that just buy time.

Exhibit 1 – RMB Use In Trade Transcends USD



Source: SAFE and Staff calculations.

Notes: Includes receipts and payments between domestic non-banking sectors and non-residents through domestic banks, excluding receipts and payments in cash.

Exposure Types and Significant Changes

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

- We increased our local currency exposure in Thailand, Malaysia, and Indonesia. EM Asia's local duration looks more attractive now given the outlook for rate cuts in the U.S. (which has priced out roughly four cuts this year. In addition, Asian EMs can benefit from China's measures to support the housing sector and prop up growth. These factors improved the technical test score for all three countries. Further, Thailand's stronger than expected Q1 GDP growth can ease pressure on the central bank to cut rates, while Thailand's tourism is doing well (including tourists from China). This strengthened the economic and policy test scores for the country.

- We also increased our hard currency corporate exposure in Qatar and the United Arab Emirates. We were motivated by recent geopolitical developments in which the friction has moved from within the region to between bigger players in the region (the battle is Israel v. Turkey v. Iran, with Israel v. Hamas largely contained so far), as well as China's authorities push to resolve the housing crisis and improve the growth outlook, which should support the outlook for commodity prices, including oil. Further, the gradually cooling U.S. economy points to further disinflation, leaving room for the Fed rate cuts and supporting duration. In terms of our investment process, this improved the technical test scores for both countries.

- Finally, we increased our local currency and hard currency sovereign exposure in South Africa, and hard currency corporate exposures in China. China's increase was due to a larger and more targeted support for housing, including unfinished projects and unsold housing stock. This is a move in the right direction, and it improved the policy test score for the country. South Africa's pre-election polls pointed to a less extreme governing coalition, against the backdrop of better fiscal outcomes and an absence of the pre-election spending spree. The coalition talks are still on-going, but there is a good chance of having a market-friendly alliance between the ANC and the DA party. If this scenario materializes, it will improve the policy test score for the country.

- We reduced our local currency exposure in Brazil. The central bank is poised to pause as inflation expectations continue to drift higher (including the expectations for 2026 lately). The pace of fiscal consolidation also looks less certain, while the appointment of the central bank's new governor might push towards more policy easing than necessary. In terms of our investment process, this weakened the economic and policy test scores for the country. The market is bullish, but likely unprepared for a long policy debate on the status of the central bank.

- We also reduced our hard currency quasi-sovereign exposure in Mexico (Pemex), and local currency exposure in Singapore. We used Singapore's bond as a funder for other higher-yielding opportunities. Bonds issued by Mexico's state-owned petroleum company PEMEX staged a nice rally recently, due to continued government support for the oil producer; that support is significantly already priced and was the basic thesis for the investment, so we decided to take profits on this position. Pemex also has a layer of ESG risk that may not be priced into the bonds.

- Finally, we reduced our hard currency sovereign exposure in Gabon and local currency exposure in Kenya. Our meeting with Gabon's country delegation raised several concerns, including the government's intention to issue more sovereign bonds despite a great deal of fiscal uncertainty and with no clear explanation regarding the use of proceeds. In Kenya, we are getting negative signals about the government's ability to boost revenue collection (as well as taxes on local financial instruments). These developments weakened the policy test scores for both countries, and we decided to take profits in Kenya as local bonds rallied a lot since we bought them.

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