June 2022

# Nervously Pessimistic

**Eric Fine**

Portfolio Manager

## VanEck Emerging Markets Bond Fund

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

### Overview

The Fund was down 6.57% based on net asset value in June, compared to its benchmark, J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified and 50% J.P. Morgan Emerging Markets Bond Index (EMBI), which was down 5.33%. June's 124 bps of underperformance compares to year-to-date (YTD) outperformance of 296 bps.

Outflows are a key market driver, consistent with later-stages of selloffs, but exaggerating weakness. Up until April, the market was a more straightforward place in which we could "hide". Being okay with local currency early in the year, then adjusting to long duration (and not local currency) starting in May, and not owning Russia could actually shine through to (out) performance. Now, though, with an outflow-driven market, that's just not the dynamic. Some countries with IMF programs and established financing are seeing their bonds sell off simply due to their smaller sponsorship combined with outflows. That is not the time to sell, and usually marks the beginning of a renaissance, but it doesn't mean it's turning around immediately. Our big risk is that we are very underweight EMFX with only around 20% of the Fund exposed (the minimum). This can't continue for too long, we believe. Either the U.S. Federal Reserve ("Fed") will blink (less likely) or the selloff in risk will continue until recession is priced – this is why we are so respectful of the curve inversion. That time is not far away, now!

We underperformed particularly due to Mexico, one of our few local-currency exposures. Ecuador and Sri Lanka also both sold off a lot. Ecuador has a funding program with the IMF, and Sri Lanka is moving towards one, but that doesn't matter near-term given the above. Egypt, Chile, Brazil, and Thailand were all winners…but they were winners because we didn't own them (we owned Brazil in USD but not in BRL). As of end-June, we reduced local currency to about 20% (our minimum), our carry[1] remains high at 6.1%, and duration is up to 8.0.

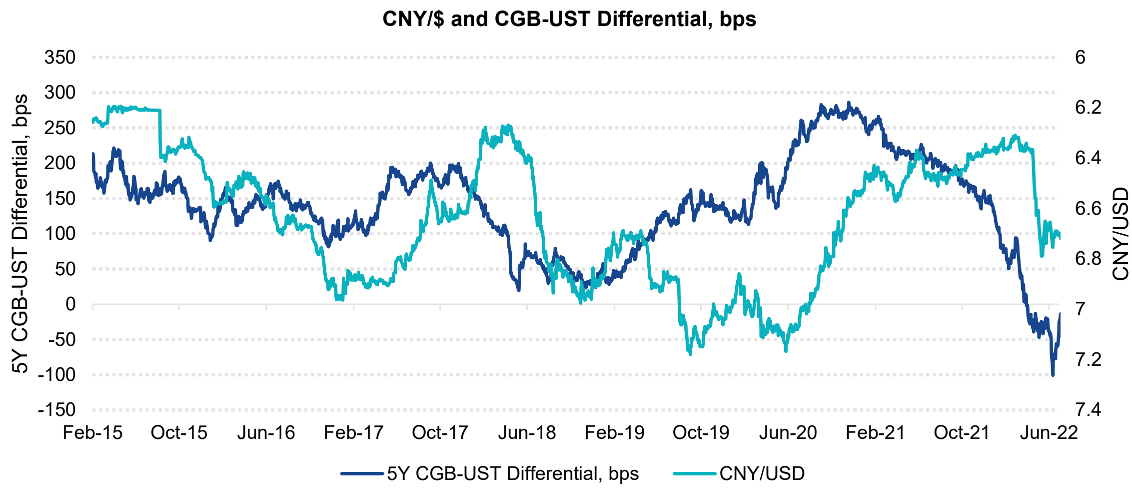
**Our basic view remains. We believe curve inversion is coming, and will have very different asset price implications than a shift up in the yield curve – it is bullish for low-beta duration and bullish for the USD generally.** The dollar should benefit from a higher rate differential against many majors, including Japan and the Eurozone; it is hard to see them getting ahead of the Fed anytime soon, if ever. Our view was, and remains, that recession risk is the key market driver. In particular, if inflation surprises on the upside, we think that at this stage the 30-year (our focus, but the 10y is the more popular one) should rally. It has, and this is important; it means recession risk is the driver. And when you see a cutting cycle priced for the end of this very year (!), it has to make you nervously pessimistic.

China remains a rising risk, mostly to the downside, in our view. The currency seems ripe for weakness, and this would affect all EMFX. Policymakers – uncharacteristically, in our view – have let the real estate crisis get ahead of them. (And Europe looks very vulnerable, but that's for another monthly.) We aren't interested in Chinese local currency bonds at lower (much) nominal yields than the U.S.' (which should go without saying). While they are cheap in real terms, it is not a rallying-cry in this kind of market. We've said since we wrote "Evergrande is Spreading " that this maps to the currency, CNY. And, most important, the government can't get ahead of the real estate crisis, we think. Mortgage non-payment, is a thing now, and maybe legitimately so, as the pre-payment model didn't work. This is a step away from a bank run. We expect China to get ahead of these kind of things and they aren't.

[1] Carry is defined as Current Yield. 30-Day SEC Yield for Class A was 6.75% as of 6/30/2022.

**We are nervously pessimistic. Everyone expects a recession, stocks can't seem to get off their knees, Euro is breaking 1 with no obvious level at which to stop, and ditto with Sterling. But, Fed Futures are already pricing a cutting cycle starting next year (!) and EMFX looks way oversold. Our defensive stance doesn't have many months more to last, we reckon.** It seems relentless. But, USD strength will eventually kill the U.S. economy and force the Fed to blink. Aren't we fun in this monthly! Sorry, but that's the basic dynamic. Call us old-fashioned but the USD will tighten conditions, kill the S&P 500, which will kill global investment. Then the Fed will have to blink. As we've been saying in our regular meetings with our active portfolio manager colleagues, they aren't blinking this weekend. China concerns keep us a little less nervous about our pessimism, meaning it could surprise markets to the downside.

### Exhibit 1 – China Nominal Rates Not Keeping Up With US Rates...CNY Pressured




Source: Bloomberg. Data as of June 30, 2022.

**The Revenge of the 60/40 model. 60/40 not working at near-zero yields should not be an insight. 60/40 working at much higher nominal yields should not be an insight either – but it is! The first step will be to move record-high cash balances earning nothing to 2-year bonds at 3%. That'll be the beginning of the Revenge story (which always includes a battle scene in which the U.S. dollar defeats all other currencies), which just opened in theaters. Next for inflows come investment grade (IG), then high yield (HY) and emerging markets (EM), we reckon the latter two by 4Q. The issue is more "when" than "whether", we think.** EM is still acquitting itself. First, EM debt sold off relative to a rallying treasury market in June. So, if treasuries are driving this whole thing, keep that divergence in mind – it's likely temporary. Also, we updated the efficient frontier to see whether the recent selloff has meant anything for recommended allocations to EM. It hasn't! You're still supposed to own much more than the 3% that is typical in U.S. institutions and the 10%-plus that can be typical in Asian and European institutions. The "right" answer from a purely efficient frontier perspective is 4%-13% at a very low volatility level of 3.5 to 4.0. Look at the table closely and you'll see that one is "supposed" to have more of EM debt (HY in particular) than Treasuries. And at more normal volatility targets like 6, you are supposed to have roughly half your fixed income (yes, 50%) in EM debt and almost all the rest in Treasuries. It makes you think, and certainly makes you want to prepare for any turn. Note that we updated to capture part of the recent selloff and it now incorporates 19 years of data.

### Exhibit 2 – How Much EM Debt in Your Fixed Income Allocation? A Lot!

**USD-based global fixed income portfolio's efficient frontier and implied weights (CEMBI details, EMBIG details)**
Data set - monthly, 2003-2022 (Jan-May)

| | LOW RISK ← | | | | | | | | | | | | | → HIGH RISK |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Portfolio st dev | 3.46 | 3.52 | 3.81 | 4.14 | 5.03 | 5.16 | 5.97 | 6.57 | 6.61 | 6.71 | 10.37 | 10.80 | 11.20 | 12.88 |
| GBI-EM | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| EMBIG HY | 4% | 6% | 13% | 20% | 36% | 38% | 50% | 59% | 59% | 61% | 100% | 77% | 59% | 0% |
| CEMBI HY+ | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 23% | 41% | 100% |
| Global Aggregate | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| Global Treasury | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| Global government related | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| Global corporates | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| Global securitized | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| US Aggregate | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| US HY | 18% | 18% | 17% | 16% | 11% | 11% | 7% | 5% | 5% | 4% | 0% | 0% | 0% | 0% |
| Euro Agg | 23% | 21% | 12% | 4% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| US Treasury | 55% | 55% | 58% | 60% | 52% | 51% | 42% | 36% | 36% | 35% | 0% | 0% | 0% | 0% |
| CEMBI IG+ | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| EMBIG IG | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| EM FI (GBI-EM, EMBIG, CEMBI) | 4% | 6% | 13% | 20% | 36% | 38% | 50% | 59% | 59% | 61% | 100% | 100% | 100% | 100% |

Source VanEck Research. 2003-2022. Asset classes in the above table are represented by major indices. Please see index definitions on Page 4.

**Exposure Types and Significant Changes**

The changes to our top positions are summarized below. Our largest positions in June were Mexico, Malaysia, Colombia, Poland, Peru and Brazil:

- We increased hard currency sovereign exposure in China and local currency exposure in Poland. In China, we added longer-dated sovereign bonds to express our view that a growing recession risks in developed markets (DM) will continue to push down longer DM yields, and that selected sovereign bonds in EM will be able to catch this duration ride. In terms of our investment process, this improved the technical test score for China. Poland is expected to benefit from the resolution of the situation with the EU funds, after President Andrzej Duda signed a bill that created a new accountability panel for judges, replacing the contentious disciplinary body. There is a risk of a dovish policy turn, but the central bank is still expected to continue hiking in order to contain inflation pressures. In terms of our investment process, this improved the policy test score for the country.
- We also increased our hard currency sovereign exposure in the Bahamas and Jordan. The Bahamas bond was a new issue that is expected to benefit from the government guarantee, and as a result, the improved technical test score. In Jordan, authorities continue to conduct adequate policies (including a 50bps rate hike by the central bank). In addition, there are signs of stronger cooperation with the Saudi Arabia, such as the Saudi government allowing the Bank of Jordan to open its branches in the Kingdom. In terms of our investment process, this improved the policy test score for the country.
- Finally, we increase hard currency sovereign exposure in Gabon and the Republic of the Congo. With regards to Congo, we continued to increase the position we already had in the country, and this decision reflected fairly decent progress towards an IMF deal (and the resulting improvements in the policy test score for the country). Gabon's economy is heavily reliant on oil, so it can benefit from higher oil prices. Sovereign bonds, however, sold off lately, improving valuations (and the technical test score for the country).
- We reduced our local currency exposure in the Czech Republic and Indonesia. The incoming dovish governor of the Czech National Bank, who is also a political appointee, and the dovish makeover of the central bank's board mean a higher chance of a policy mistake (such as a prolonged pause after a higher than expected rate hike in June). This, in our opinion, worsened the country's policy test score. With regards to Indonesia, we are concerned that higher gasoline and diesel prices can compromise the fiscal consolidation program, and also negatively affect the trade balance and inflation. In terms of our investment process, this worsened the economic test score the country.
- We also reduced our hard currency exposure in Israel and Argentina. Israel's spread-to-yield ratio is among the lowest in the EM Fixed Income universe, which makes it a U.S. Treasury proxy, and so we used it as a funder for other – more interesting – opportunities. Argentina's policy and economic landscape continues to deteriorate, especially as regards budget performance and the government's inability to meet not-terribly-ambitious IMF fiscal targets. The central bank debt financing does little to improve investors' sentiment. We are also concerned about the on-going decline in the international reserves, despite good seasonality. In terms of our investment process, this worsened the economic and policy test scores for the country.
- Finally, we reduced hard currency sovereign exposure in Ukraine. We were taking partial profits for a couple of months, but we decided to exit altogether due to a much higher risk of default because the international help is not enough/too slow coming to help cover the circa USD5bn per month fiscal deficit, which can affect the government's ability to meet its near-term debt obligations. In terms of our investment process, this worsened the policy and economic test scores for the country.

### Average Annual Total Returns (%)

| As of June 30, 2022 | 1 Month† | 3 Month† | YTD | 1 Year | 3 Year | 5 Year | Life |
|---|---|---|---|---|---|---|---|
| Class A: NAV (Inception 7/9/12) | -6.57 | -10.86 | -14.48 | -18.50 | -2.27 | -0.06 | 0.56 |
| Class A: Maximum 5.75% Load | -11.94 | -15.98 | -19.40 | -23.19 | -4.18 | -1.23 | -0.04 |
| Class I: NAV (Inception 7/9/12) | -6.43 | -10.73 | -14.31 | -18.23 | -2.00 | 0.25 | 0.85 |
| 50 GBI-EM GD / 50% EMBI GD | -5.33 | -10.03 | -17.44 | -20.22 | -5.46 | -1.69 | 0.77 |

| As of March 31, 2022 | 1 Month† | 3 Month† | YTD | 1 Year | 3 Year | 5 Year | Life |
|---|---|---|---|---|---|---|---|
| Class A: NAV (Inception 7/9/12) | -0.74 | -4.06 | -4.06 | -5.00 | 2.75 | 2.64 | 1.77 |
| Class A: Maximum 5.75% Load | -6.45 | -9.58 | -9.58 | -10.46 | 0.74 | 1.43 | 1.15 |
| Class I: NAV (Inception 7/9/12) | -0.84 | -4.01 | -4.01 | -4.79 | 3.06 | 2.92 | 2.05 |
| 50 GBI-EM GD / 50% EMBI GD | -1.21 | -8.24 | -8.24 | -7.95 | -0.51 | 0.99 | 1.47 |

† Returns less than one year are not annualized.

**Expenses: Class A: Gross 2.30%; Net 1.25%.** Expenses are capped contractually until 05/01/23 at 1.25% for Class A and 0.95% for Class I. 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 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.

### Index Definitions

**GBI-EM:** The J.P. Morgan GBI-EM Global Diversified tracks local currency bonds issued by Emerging Markets governments.

**EMBIG HY:** The J.P. Morgan EMBI Global Diversified High Yield index tracks returns for actively traded external high yield debt instruments in emerging markets, and is also J.P. Morgan's most liquid U.S dollar emerging markets high yield debt benchmark.

**CEMBI HY+:** The J.P. Morgan Corporate Emerging Markets High Yield Bond index tracks U.S. dollar high yield bonds issued by emerging markets corporates.

**Global Aggregate:** Bloomberg Global-Aggregate Total Return Index Value Unhedged USD is a sub-index of the Bloomberg Global Aggregate Index, which is a flagship measure of global investment grade debt from twenty-four local-currency markets.

**Global Treasury:** The Bloomberg Global Treasury Index tracks fixed-rate, local currency government debt of investment grade countries, including both developed and emerging markets.

**Global government related:** Bloomberg Global Aggregate Government Related Total Return Index Value Unhedged USD tracks global government debt issues.

**Global corporates:** The Bloomberg Global Aggregate Corporate Index is a flagship measure of global investment grade, fixed-rate corporate debt.

**Global securitized:** The Bloomberg Global Aggregate - Securitized Index tracks Securitized (Class 1= Securitized) bonds from the flagship Global Aggregate Index.

**US Aggregate:** The Bloomberg US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.

**US HY:** The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market.

**Euro Agg:** The Bloomberg Euro-Aggregate Index is a benchmark that measures the investment grade, euro-denominated, fixed-rate bond market, including treasuries, government-related, corporate and securitized issues. Inclusion is based on currency denomination of a bond and not country of risk of the issuer.

**US Treasury:** The Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.

**CEMBI IG+:** The J.P. Morgan Corporate Emerging Markets High Yield Bond index tracks U.S. dollar investment grade bonds issued by emerging markets corporates.

**EMBIG IG:** The J.P. Morgan EMBI Global Diversified Investment Grade index tracks returns for actively traded external investment grade debt instruments in emerging markets, and is also J.P. Morgan's most liquid U.S dollar emerging markets investment grade debt benchmark.

Source: Bloomberg LP and JP Morgan Index Research

## Disclosures

**International Monetary Fund (IMF)** is an international U.S.-based organization of 190 countries focused on international trade, financial stability, and economic growth.

**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 mea- sure 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.

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.

All indices are unmanaged and include the reinvestment of all dividends, but do not reflect the payment of transaction costs, advisory fees or expenses that are associated with an investment in the Fund. Certain indices may take into account withholding taxes. An index's performance is not illustrative of the Fund's performance. Indices are not securities in which investments can be made. The Fund's benchmark index (50% GBI-EM/50% EMBI) is a blended index consisting of 50% J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified and 50% J.P. Morgan Emerging Markets Bond Index (EMBI). The J.P. Morgan GBI-EM Global Diversified tracks local currency bonds issued by Emerging Markets governments. The J.P. Morgan EMBI Global Diversified tracks returns for actively traded external debt instruments in emerging markets, and is also J.P. Morgan's most liquid U.S dollar emerging markets debt benchmark. The S&P 500® Index consists of 500 widely held common stocks covering the leading industries of the U.S. economy.



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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 for performance information current to the most recent month end and for a free prospectus and summary prospectus.**

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