

# U.S. Default Risk Creates EM Tailwinds



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Are EM currencies poised to breakout? US default risk and the concern over the USD's reserve currency status conspire against the US dollar and are positive tailwinds for EM debt.

In April, the [VanEck Emerging Markets Bond](#) Fund returned 0.57%, compared to 0.70% for its benchmark. Year to date, the Fund returned 4.17%, in line with its benchmark which returned 4.23%. Fund winners included Zambia in local currency and Egypt (not owning it). Fund detractors included Mexico (not owning Mexico in local currency) and Argentina (the Fund has some exposure which weakened in April). As of end-April, local currency exposure was around 56.01%, duration was 5.58 and carry was around 5.46%. Indonesia, Malaysia, Thailand, South Africa, and Chile remain the Fund's largest exposures, and the Fund has limited exposure to high-beta emerging markets (EM) currencies such as the Mexican peso, South African rand, and Brazilian real.

### Average Annual Total Returns (%) as of April 30, 2023

	1 Month <sup>†</sup>	3 Month <sup>†</sup>	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 7/9/12)	0.57	-0.81	4.17	5.48	7.26	1.38	0.19
Class A: (Maximum Sales Charge) % load	-5.21	-6.52	-1.82	-0.59	5.16	0.18	-0.40
Class I: NAV (Inception 7/9/12)	0.78	-0.53	4.22	5.93	7.64	1.71	0.50
Class Y: NAV (Inception 7/9/12)	0.76	-0.60	4.36	5.84	7.57	1.65	0.44
50% GBI-EM / 50% EMBI	0.70	0.48	4.23	2.83	-0.30	-0.85	0.05

### Average Annual Total Returns (%) as of March 31, 2023

	1 Month <sup>†</sup>	3 Month <sup>†</sup>	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 7/9/12)	1.50	3.58	3.58	-0.38	8.30	0.85	0.33
Class A: Maximum 5.75% load	-4.34	-2.38	-2.38	-6.11	6.19	-0.34	-0.26
Class I: NAV (Inception 7/9/12)	1.52	3.42	3.42	-0.04	8.60	1.14	0.63
50 GBI-EM GD / 50% EMBI GD	2.54	3.51	3.51	-3.81	0.48	-1.43	0.29

<sup>†</sup> Returns less than one year are not annualized.

**Expenses: Class A: Gross 2.55%, Net 1.27%; Class I: Gross 2.51%, Net 0.97%; Class Y: Gross 2.91%, Net 1.02%.** 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.

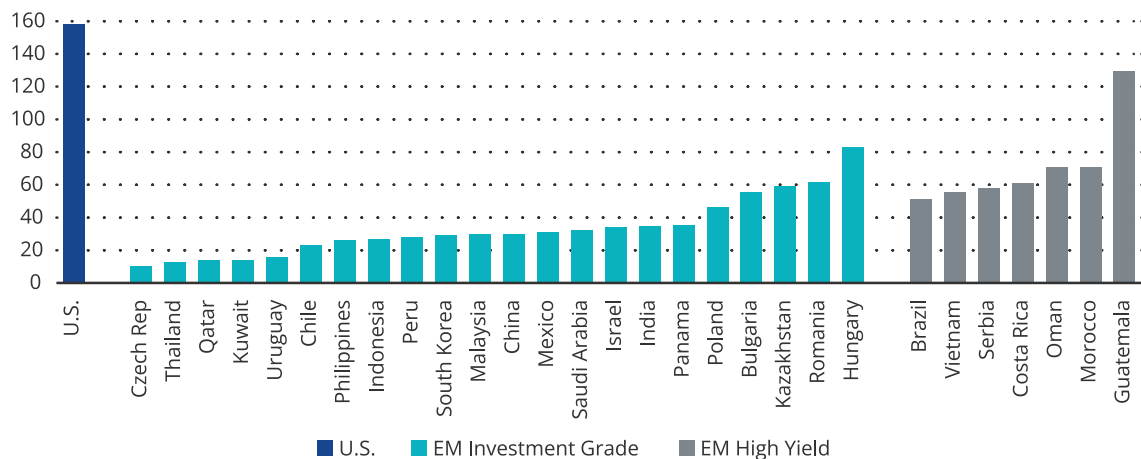
Expenses are capped contractually until 05/01/24 at 1.25% for Class A, 0.95% for Class I, 1.00% for Class Y. Caps excluding acquired fund fees and expenses, interest, trading, dividends, and interest payments of securities sold short, taxes, and extraordinary expenses.

**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](http://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.

**The next “big thing” is US technical default risk, but denial/complacency reign – the credit default swap (CDS) market is already suggesting that the odds of US default are higher than Guatemala’s.** There is now substantial default risk priced in by the 1-year CDS market, which means that anyone who buys Treasury Bills (T-Bills) is not getting paid for that risk. Exhibit 1 shows 1-year CDS spreads for the US versus some EM countries. With the US at around 160 basis points (bps) and Guatemala at 130 bps (and Brazil around 50 bps), the market is suggesting that the chance of default by the US on USD-denominated debt is *substantially* higher than the chance of default by Guatemala or Brazil on USD-denominated debt. That 160 bps of credit default premium that you are *not* getting paid for in your T-Bills is almost *half* of the T-Bill yields. Are you sure you feel safe in T-Bills when an observable market is already telling you that you aren’t getting paid enough?

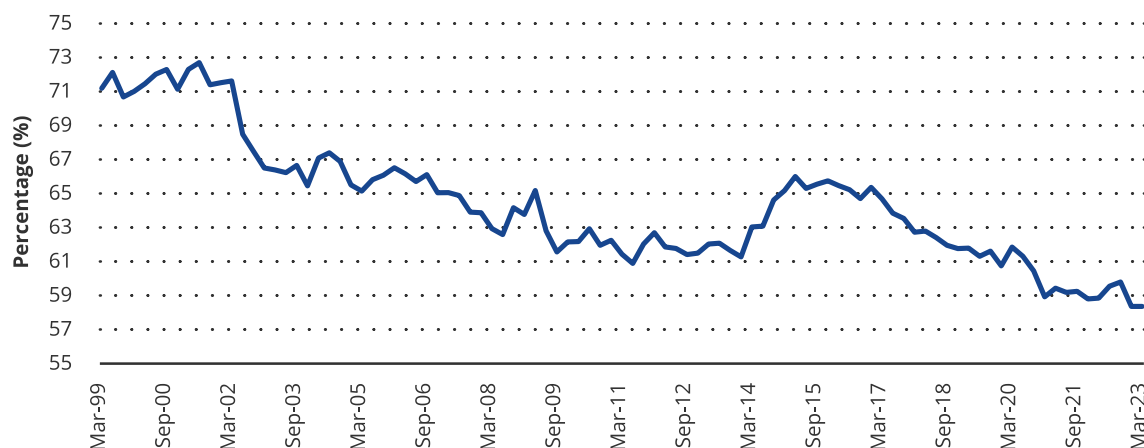
**Exhibit 1: Implied Probability of Default is Higher for US Than for Guatemala**  
U.S. vs. EMs - 1-year CDS (bps)



Source: Bloomberg. As of May 12 2023. For illustrative purposes only. Not intended as a forecast of future events. Actual future default events or lack thereof are unknown.

**Geopolitics is the other “big thing”, probably the “next” market driver, but also met with denial and complacency; the US dollar will also suffer from this.** It was only a year-plus ago that we asked in our monthly commentary why central banks outside the US orbit would own US Treasuries, following sanctions on Russia’s central bank. In recent months we have seen concretization of greater use of EM currencies in trade (for example, recent agreements between Saudi Arabia/China, United Arab Emirates (UAE)/India, Brazil/China to conduct purchases of oil or other resources using their own currencies instead of the US dollar). China has been able to reduce about a third of its US Treasuries and it appears that more central banks will go down this path. But, as we’ve noted, this is a multi-year process. Nonetheless, the strong performance of EM currencies YTD during a US banking crisis testifies to markets being open to many EMs as safe havens. And, this process of replacing central bank reserves in US Treasuries with reserves in EM bond markets is clearly a tailwind, however many years the various processes.

**Exhibit 2 - USD Share in International Reserves Declining**  
USD Share in Total Allocated International Reserves, %



Source: Bloomberg, IMF. As of April 2023. Past performance does not guarantee future results.

**This combination of default risk combined with already-ignited concern over the USD's reserve currency status conspire against the US dollar and make duration questionable.** Now, the first decline in the US dollar may not trigger much of a reaction (other than boosting our p/l) by policymakers. But, after a sustained and significant US dollar drop, and another phase of inflation concern (due to USD weakness), the only recourse will be for the Fed to *hike* rates. This will be the only tool that can prevent a doom-loop for the US dollar. Given growing recessionary risks as well as the ongoing run on US bank deposits, we continue believe the Fed is in a corner. And, if the Fed is pausing for now and perhaps risking cutting rates, that, too, is good for our EM local currency positions.

## Exposure Types and Significant Changes

The changes to the Fund's top positions are summarized below. Our largest positions in April were Indonesia, Malaysia, Thailand, South Africa, and Chile:

- We increased our local currency exposure in Poland. The country's inflation had finally peaked, but unlike some regional peers, the central bank is not in a hurry to start easing. Further, the occasional political noise notwithstanding, Poland's relations with the European Union are still good enough to keep the flow of funds going uninterrupted. We are naturally concerned about the elections' impact on fiscal performance in 2023, but Poland always managed to surprise to the upside in these situations before. We also keep a very close eye on the geopolitical developments in the region, and we think that China's more vocal position (including the call with Ukraine's President Zelenskyy) might be a positive signal for the entire region and Poland in particular. In terms of our investment process, this improved the policy test score for the country.
- We also increased hard currency quasi-sovereign exposure in Colombia and the UAE, and hard currency sovereign exposure in Bahrain. The unified theme here is OPEC's decision to cut the oil output, which is supplemented by Bahrain's move to restore relations with Oman after boycott, and Colombia's bottoming current account balance. Our quasi-sovereign choice in the UAE is a more attractively valued investment opportunity (compared to the sovereign). In terms of our investment process, this improved the technical test score for all three countries.
- Finally, our local currency exposure in Zambia also increased, but this reflected sizable appreciation of the Zambian Kwacha. The currency's strength in part reflected technical factors (like tax payments), but also optimism on the debt restructuring progress due to China's greater involvement on the official creditors' side.
- We reduced our local currency exposure in Brazil and Uruguay – in part due to concerns about the impact of the growth cliff in the US under an unfavorable debt ceiling scenario (no resolution before the X-date). In terms of our investment process, this meant the deteriorating technical test score for both countries. Brazil's local bonds can also be affected by a lack of clarity on the government's fiscal plans, as well as attempts to modify the minimum wage formula that can boost both spending and inflation expectations. Both factors worsened the policy test score for Brazil.
- We also reduced our local currency exposure in South Africa. The US debt ceiling/growth cliff concerns played a part in our decision, but in addition, we also see limited room for additional fiscal improvements due to widespread blackouts. At the same time, near-term inflation pressures might prove stronger than expected, necessitating more policy tightening by the central bank. In terms of our investment process, this worsened the technical and policy test scores for the country.
- Finally, we reduced our local currency exposure in Israel due to persistent political noise over judicial reform, which overshadows such positive developments as peaking inflation and the policy rate, healthy growth, and a large current account surplus. A cabinet minister's call to replace the central bank's governor with a robot did not help to improve sentiment. Unresolved political issues also cast a shadow over longer-term foreign direct inflows, and the vibrancy of the country's tech sector.

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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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