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What Happens After a Santa Rally in Rates?

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> The Fed is done hiking, and there are plenty of reasons to think that rates further out the yield curve – perhaps after a Santa rally in rates that could last through year-end – could continue to push higher.

In October, the **VanEck Emerging Markets Bond Fund** declined 1.25% versus a 0.94% decline 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), underperforming by 31 basis points (bps),. We leaned into the recent sell-off in U.S. rates by increasing our below-benchmark duration and by increasing exposure to higher-beta emerging markets (EM) local currency markets. Duration had been around 3, it's now around 4 (and heading to 5), and we added in Mexico, Hungary, South Africa, and Czechia, all in local markets. We end October with carry of 7.0%, Yield to worst of 10.6%, duration around 4, and 47% of the fund in local currency. Our biggest exposures are Mexico (local and hard), Brazil (local and hard), China (local and hard), Malaysia (local), and Colombia (local and hard).

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

	1 Month†	3 Month†	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 07/09/12)	-1.44	-6.29	0.88	14.15	-1.29	2.00	0.69
Class A: Maximum 5.75% load	-7.11	-11.68	-4.92	7.59	-3.22	0.80	0.09
Class I: NAV (Inception 07/09/12)	-1.24	-6.20	1.07	14.52	-0.97	2.32	1.00
Class Y: NAV (Inception 07/09/12)	-1.25	-6.21	1.14	14.35	-1.08	2.25	0.93
50% GBI-EM/50% EMBI	-0.94	-5.89	2.09	10.97	-3.95	0.10	0.50

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

	1 Month†	3 Month†	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 07/09/12)	-2.28	-3.37	2.35	12.91	-0.83	2.07	1.18
Class A: Maximum 5.75% load	-7.90	-8.93	-3.53	6.42	-2.77	0.87	0.58
Class I: NAV (Inception 07/09/12)	-2.43	-3.46	2.34	13.01	-0.56	2.39	1.48
Class Y: NAV (Inception 07/09/12)	-2.44	-3.49	2.43	12.95	-0.62	2.32	1.42
50% GBI-EM/50% EMBI	-2.98	-2.73	3.06	11.61	-3.58	-0.12	0.87

† 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.*

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.

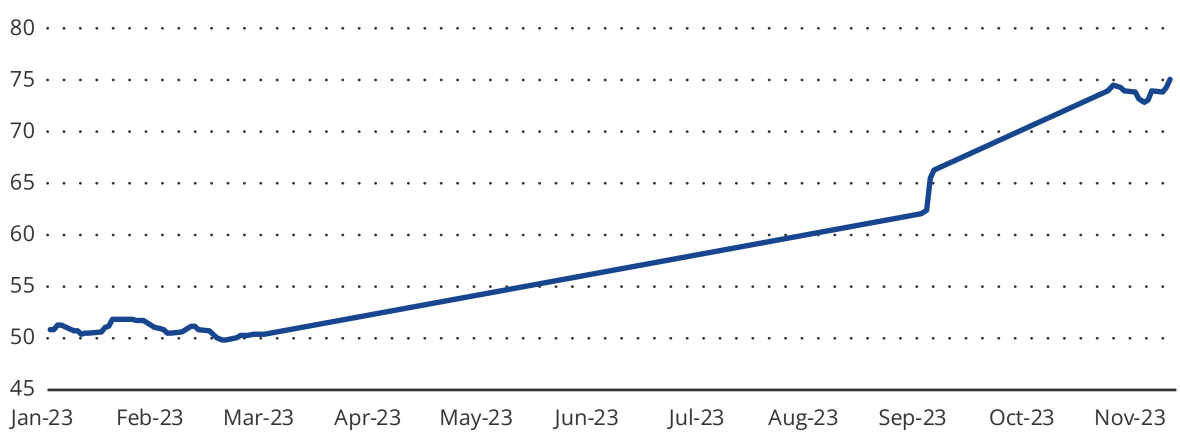
The "Net Asset Value" (NAV) of a Fund is determined at the close of each business day, and represents the dollar value of one share of the fund; it is calculated by taking the total assets of the fund, subtracting total liabilities, and dividing by the total number of shares outstanding. The NAV is not necessarily the same as the ETF's intraday trading value. Investors should not expect to buy or sell shares at NAV.

Peak Fed = Peak Dollar? The clearest implication of the pause in U.S. policy rates is a weaker dollar. An end to Fed hikes is now clearer following U.S. CPI data released on October 14. Disagreement is now mainly about how long it will take for cuts to materialize and their magnitude, not the general sequencing and direction of the next year. To us, the main point is that the Fed appears to be done hiking, but not done talking about it. Whether this "pause" at the front end of the yield curve translates into a rally in the long end (which would at least need support from further favorable inflation data in the coming months, if not a recession), or whether the pause at the front end translates into a sell-off in the long end (which could happen for a variety of reasons including poor inflation data, weak market demand for duration, U.S. credit risk, and others), the pause at the front end is the clearest observation. Our mantra remains "the turn in rates is not the turn in risk." An end to hikes is not the cue to buy 30-year bonds or high yield, any more than it's the cue to buy the Nasdaq. The pause should anchor front-end rates, and thus the only clear asset price implication is that it freezes support for the U.S. dollar. When/if the Fed takes it further and stops jawboning in this direction, we reckon that more policy rate cuts will be priced. Whether long-end yields will be higher or lower, on the other hand, will be largely a function of U.S. inflation data and recession risk. Policy rates, less so. As a result, we see the only and key market implication to be bullish for EM currencies against the U.S. dollar.

Peak Fed = Peak Duration? "The turn in rates is not the turn in risk", we've been saying. Our view on duration is now neutral, having been bearish for most of this year. The Fund had duration of around 3 for most of the year going into September, was around 4 at the end of October, and is approaching 5, as of mid-November. We have taken profits on our low duration view, and have brought the Fund's duration close to benchmark duration (of around 5.6). The turn in policy rates is only the turn in policy rates. As we argue above, there are plenty of reasons to think that rates further out the curve – perhaps after a Santa Claus rally in rates that could last through year-end – could continue to push higher. For reasons we've written about, ranging from ongoing QT, high and relentless treasury borrowing and credit concerns. But, these are reasons to concentrate on the more durable driver – policy rates. Anchored policy rates are the stronger conclusion from recent developments. As a result, the Fund had increased EM currency exposure, including to higher-beta Brazil, South Africa, Mexico, and Colombia...but only took our duration underweight closer to neutral. The turn in policy rates is only the turn in policy rates.

Peak Fed = Peak geopolitical stability? There is still commodity supply risk, despite oil's decline in the wake of the surprise October 7 attacks on Israel. We think this price decline reflects major powers' efforts to keep the conflict from escalating, but it does not mark the end of geopolitical risk. Since the October 7 attacks on Israel by Hamas, oil prices are down over 10%, contrary to a knee-jerk expectation of $100 oil following this spike in geopolitical risk. To us, oil's underperformance relative to the geopolitical "noise" is almost entirely a reflection of the U.S. and key regional powers' efforts to keep the conflict from spilling into a broader one. Given the obvious capacity for this conflict to escalate, our flashlight only goes out a few months on this topic, but it seems to us that the intent and interest of the U.S., its Sunni allies, Iran, Saudi Arabia, and China point in the direction of stability. Israel and events may not cooperate, of course, but Israeli Prime Minister Benjamin Netanyahu's political vulnerability at home is also appearing to be a constraint on escalation for now. Looking further out, this conflict has much that could easily spill into a conflict with more serious market implications. Sunni nations need to avoid looking like vassals and Israel's actions need to be modulated to reduce the risk of a rising "Arab street", but is this likely? For now, containment of the crisis is actually happening. It might not continue, of course. But, our point is that oil's weakness in the wake of October 7 is the result of a common front against escalation against key powers surrounding the actual conflict, which looks fragile. Supply risk to commodities, generally speaking, is still the key long-term fact. The example of uranium is instructive. Uranium spiked following the coup in Niger, a heretofore important supplier to France. Like a number of commodities, uranium supply can be very concentrated, and Kazakhstan happens to produce 40% of global uranium. In any case, our point is that geopolitics still point to supply risk, but this doesn't mean there's a catalyzing event every quarter. The chart below shows that one simply has to be ready for it. As such, we're chalking up oil's weakness in the wake of October 7 to a configuration of restraint and containment. The geopolitical risk is still there, just contained.

Exhibit 1 – Uranium Reacts to Geopolitical Risk



Source: Bloomberg As of November 15, 2023

Nobody is giving China credit. In addition to a litany of what could add up to a "stimulus package" (including housing-focused spending, encouragements to reschedule domestic liabilities), the government just announced an outright 0.8% of GDP pure fiscal stimulus. And yet, we found surveys at recent IMF meetings showing that nobody was receptive to good news about China, with less than 5% of respondents indicating any interest in investing in China in 2024. This is too extreme a position, in our opinion, regardless of the long-term trajectory of U.S./China relations. And, in corporate bonds there are plenty of prices that reflect this extreme bearishness (this is important because the Chinese Government Bond market shows no signs of stress and no signs of value). We continue to be constructive on selective Chinese corporate bonds, which we accumulated during this year's sell-off.

In October, the Fund underperformed by 31 bps, declining 1.25%, compared to a 0.94% decline for its benchmark. We leaned into the recent sell-off in U.S. rates by increasing our below-benchmark duration and by increasing exposure to higher-beta EM local currency markets. Duration had been around 3, it's now around 4 (and heading to 5), and we added in Mexico, Hungary, South Africa, and Czechia, all in local markets. We end October with carry of 7.0%, YTW of 10.6%, duration around 4, and 47% of the fund in local currency. Our biggest exposures are Mexico (local and hard), Brazil (local and hard), China (local and hard), Malaysia (local), and Colombia (local and hard).

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions in October were Mexico, Brazil, China, Malaysia, and Colombia.

- We increased our local currency exposure in Mexico, Chile, Hungary, and the Czech Republic. Mexico's local rates are still closely correlated with U.S. Treasuries, and as such should be expected to benefit from the Fed's perceived dovish tilt. On the other hand, Mexico's central bank is unlikely to rush into rate hikes, providing a fundamental backstop for the currency. In terms of our investment process, this improved Mexico's technical and policy test scores. The Chilean central bank adjusted the pace of easing in response to the global uncertainty, improving the policy test score for the country. The Czech national bank remains the most hawkish in the region, supporting the country's policy test score. Hungary's growth outlook is expected to improve in 2024 on the back of lower inflation, benefitting the currency, whereas the central bank should still be able to cut the policy rate safely.
- We also increased our local currency and sovereign exposure in South Africa, and sovereign exposure in Qatar and Angola. South Africa's central bank is among the most credible in EM, which means no running ahead of the curve with policy easing – especially as the government's debt trajectory might be higher and the deficit a bit wider than expected. A good thing is that the government's medium-term fiscal projections are based on reasonable economic assumptions, which should keep issuance under control. In terms of our investment process, this improved the policy test score for the country. Qatar and Angola should be expected to benefit from higher oil prices as China continues to rebound and the Middle East tensions might put a floor under the price of oil. Further, our sovereign exposure in Qatar is long-dated, and as such should be expected piggyback on the downside move in U.S. Treasury yields.
- Finally, we increased our sovereign exposure in Egypt and Nigeria. The pace of reforms in Nigeria is accelerating again (including the exchange rate unification), and it looks like the government was able to secure a decent pipeline of multinational loans to support the policy transition. In terms of our investment process, this improves the policy test score for the country. Egypt's pivotal role in the Middle Eastern conflict might result in large multinational and bi-lateral inflows, as well as potentially some positive news on the debt forgiveness front, strengthening the policy test score for the country.
- We reduced our local currency exposure in Malaysia and Thailand. These are low-yielding assets, and they might not benefit as much from a rally in U.S. rates. It also remains to be seen when these countries would feel the positive spillovers from China's rebound, as the progress is bumpy and might be slower than expected.
- We also reduced our local currency exposure in Israel. The escalation of political tensions in the region means a greater risk premium for most assets against the backdrop of downside growth risks and missed fiscal targets. In terms of our investment process, this worsened Israel's policy test score.
- Finally, we reduced our sovereign exposure in Ecuador. Even though President-elect Noboa is generally considered a business-friendly politician, the country is now in a wait-n-see mode, as the cabinet is being formed and the reform agenda formulated. In terms of our investment process, this worsened the policy test score for the country.

Disclosures

[1] Source: ICE Data Indices and J.P. Morgan as of 9/30/2023. UST 10y is measured by the ICE BofA Current 10 Year U.S. Treasury Index; Global Agg is measured by the ICE BofA Global Broad Market Plus Index; EM Blend is measured by 50% J.P. Morgan EMBI Global Diversified/50% J.P. Morgan GBI-EM Global Diversified.

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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.

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