Manager Commentary

Taper Talk Rattles Emerging Markets

By: Eric Fine, Portfolio Manager

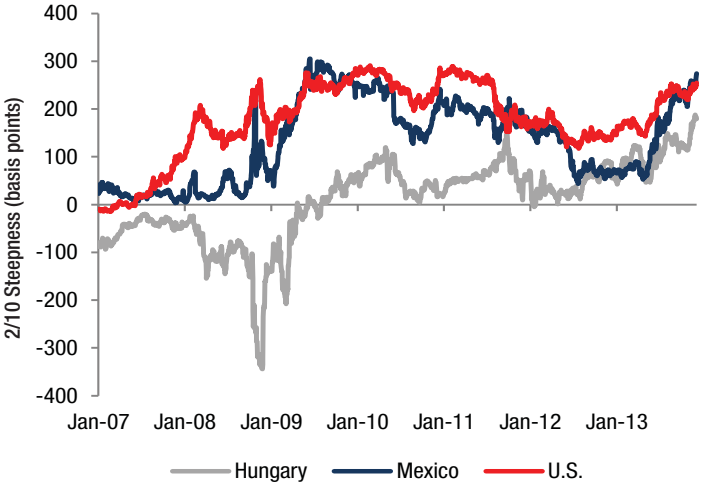
Executive Summary

- Idiosyncracy remains the name of the game
- Inflation and external balances improve in Brazil and Indonesia
- Bad news in both Venezuela and Ukraine

Overview

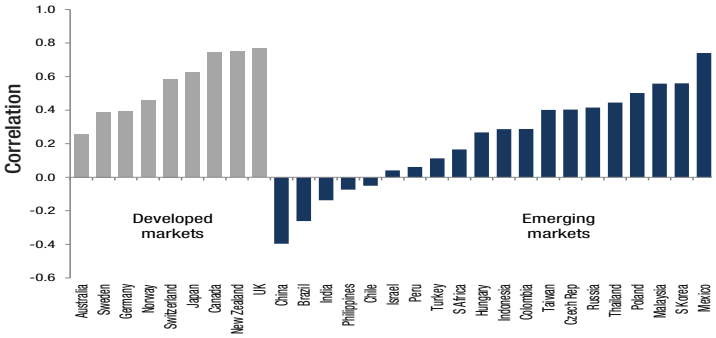
Another "taper tantrum" seemed to be the driver of asset prices in November. We believe this should fade soon. First, we've "been there before", so, by definition, the market has had time to digest and price-in the eventuality of a taper. Second, a number of key yield curves are extremely steep relative to their histories, so bearishness on duration is apparent. They could go steeper, but that would set some contemporary records (see Exhibit 1). Third, a number of EM (emerging market) economies have already seen steeper curves, higher yields, and even higher policy rates, in reaction to the market's initial taper fears. Indonesia and Brazil stand out as having hiked policy rates, intervened to stabilize their currencies, and, in our opinion, will continue to do so. Fourth, as we've argued before, EM bonds are not the only bonds subject to duration risk. As Exhibit 2 reminds us, the 2/10 (difference between 2-year and 10-year bonds) steepness of DM (developed market) bonds is more broadly correlated to the U.S. Treasury 2/10 steepness than EM bonds' correlation to U.S. Treasury 2/10 steepness.

Exhibit 1 – U.S., Hungary, and Mexico Yield Curves (2/10) are Steep Relative to History



Source: Bloomberg, Van Eck Research. Data as of December 4, 2013.
Past performance does not guarantee future results.

Exhibit 2 – DM Bonds 2/10 Steepness More Correlated to U.S. Treasury 2/10 Steepness than is EM Bonds'



Source: Bloomberg, Van Eck Research. Data as of December 5 2013.
Past performance does not guarantee future results.

EM monetary policy is becoming more idiosyncratic – some central banks are hiking, some are cutting, some are paused – indicating underlying fundamentals and asset prices that are more idiosyncratic. Some countries, such as Mexico, have cut interest rates and are, in our view, likely to continue to do so, despite central bank communications that point to a pause. Hungary is a more extreme example of this, with very high real interest rates, a central bank that has been cutting, but which also continues to indicate in its communications that further cuts are likely.

At the other end of the spectrum, we have countries such as Indonesia and Brazil, which have hiked policy rates by roughly 200 bps each, almost entirely as the result of fallout from the initial "taper tantrum" that started in May. We believe that the central banks of both these countries are not done with interest rate hikes, despite indications that their external balances are improving, inflation is declining, and that growth might suffer.

This is what we mean when we say that many EM economies have acquitted themselves in this crisis: they were willing to suffer weaker growth to combat an imbalance (in this case a current account imbalance) that the market didn't like. DM policymakers seem unable to contemplate any hit to growth, regardless of underlying fiscal or external imbalances. This has been a recurring theme in our communications. Many EM central banks protect their money regardless of short-term growth pressures, whereas DM central banks appear to reward bad policy with seemingly permanent monetary forbearance.

Please note that the information herein represents the opinion of the portfolio manager and these opinions may change at any time and from time to time.

Inflation and, more importantly, external balances, are improving in countries whose currencies saw the most weakness as a result of the "taper tantrum". Indonesia saw a November headline inflation number that was better than expected, and core inflation remained both anchored and low. More importantly, in October the country registered a trade balance surplus of $42M, much better than market expectations of a $775M deficit. And the central bank is still on a rate-hiking path. (Would a DM country be doing the same?!) To quote from a recent Moody's update on its rating following market turbulence: "Moody's Investors Service says the stable outlook for the Government of Indonesia's Baa3[1] rating is based on the country's resilient growth, low debt burden, favorable maturity profile, and high debt affordability. These positive factors help guard the economy against refinancing risks and mitigate the impact of higher interest rates and exchange rate depreciation."

The situation is the same, more or less, in Brazil. 3Q13 GDP disappointed at -0.5%, versus market expectations of -0.3%. And the country continues to hike rates. We hate to keep belaboring this, but would a DM country be doing this? No way! Brazil is protecting its money, preventing inflation expectations from getting out of control, and reducing external imbalances. Is it working? Well, November saw the country's trade surplus reach $1.7B, compared to a market consensus of $450M (and the highest forecast in the Bloomberg survey was $1B).

Not all is well in EM countries, and, in our view, idiosyncrasy remains the name of the game. We continue to have the same answer as we always do when asked: "What do you think about EM debt?" We like countries with real rates or credit spreads that are high relative to their fundamentals. And we don't like the opposite. Sticking with more "normal" countries, South Africa saw a weaker than expected current account deficit in 3Q13, at 6.8% of GDP, despite also having a dramatically weaker currency this year (down almost 30% year-to-date). Our response is to continue not to own South Africa, rather than generalize this to all EM countries.

The big bad news in EM was in Venezuela and Ukraine, though our response of simply not owning them (rather than generalizing to all EM countries) remains in place. We are, perhaps, one of the only EM bond funds to have a zero allocation to Venezuela (which is 7% of the EMBIG hard-currency index) and Ukraine in hard-currency. (As well as 0% to South Africa in local currency.) We won't repeat our arguments on Venezuela, other than to say the following: in our view, the situation is jumping the rails of the purely economic (all the stuff we've written about in the past) to the purely social. To us, social unrest seems inevitable, due to the acceleration of the economic problems we've discussed, and the fact that they are occurring under a weak President Maduro – following President Chavez's death. We don't like positioning, too, as we've mentioned before, where JP Morgan surveys see only a slight underweight. Ultimately, we do not see a default in Venezuela, and are instead looking for an entry point...just not today.

And in Ukraine it could get even worse. Here we see an actual default as possible. Poor, poor Ukraine! I've been looking at the country for 20 years, and I have a few strong opinions on it. The place is unanalyzable, and the limits to one's "normal" investment process are important to recognize. The trigger for the recent crisis is a great example. The country was supposed to sign EU trade agreements and at the last minute bailed in favor of a nebulous move towards Russia's trade zone. As a result, it is one of the few countries we are OK with buying on a rally, as we believe we have no choice but to wait until everything is certain before taking a stance. Anyway, the popular media have done a good job of describing events, so we will only ask you: "Would you lend to a country whose president is unpredictable, who may be forced out of office in a short period of time, with low reserves and high debt service?" To put it differently, we are downplaying possible "rescues" from Russia or China. Venezuela and Ukraine are two of only three countries where, according to our models, hard-currency debt has value, although we have refused to own them recently as they failed other tests in our investment process.

Finally, we were too pessimistic on Malaysia, it seems, and are, now, no longer "worried" about the country tainting its reputation for steady and good policy. Malaysian policymakers have been more disciplined than we anticipated, cutting key energy subsidies that were a fiscal concern. We thought reform momentum had died, and we were wrong. Good on Malaysia! And we should like to get that on the record.

Exposure Types and Significant Changes

Our top five positions are currently Argentina (in hard-currency), Mexico, Indonesia, Brazil, and Chile, all in local-currency. Our top five positions from last month continue in the case of Argentina (in hard-currency), and Mexico and Indonesia in local currency.

Biggest Country- and Bond-Level Changes

- We closed Portugal in hard-currency from 9% to 0%, continuing our profit-taking in peripheral Europe. Our price target was hit. And things appear to be getting worse, with uncertainty related to the roll-out of bank asset tests and related polices potentially creating some noise.

- We reduced Philippines in local-currency from 9.9% to 1.7%. We see better opportunities elsewhere. We are not happy with the wide bid/ask in some bonds, and see policymakers as perhaps desirous of a weaker currency.

- We increased Brazil in local-currency (we continue to like it, but now even more so), due to currency weakness, but especially because of ongoing sell-offs in yields.

- We decreased Colombia in local currency to 9.7% from 4.9%, due to high real yields.

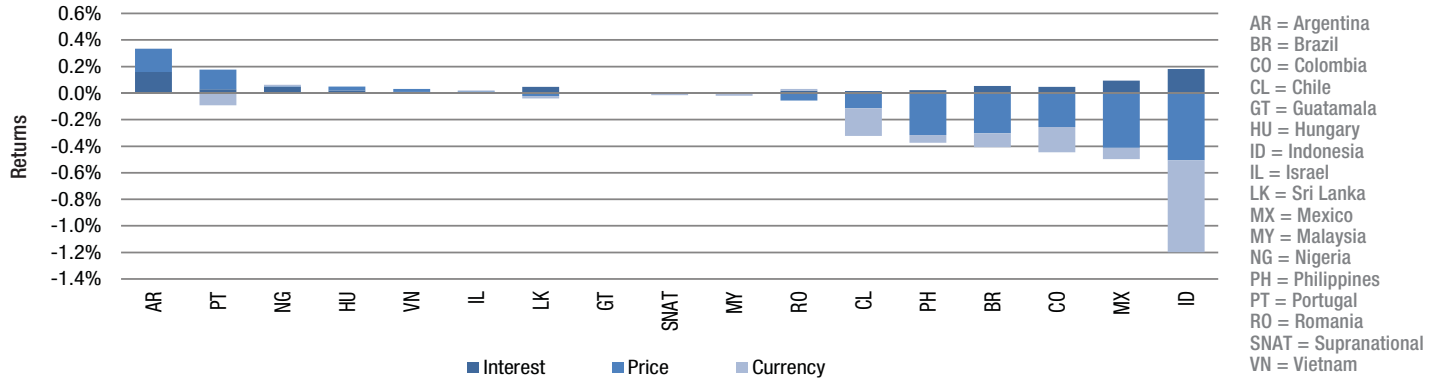
- We also increased Chile in local currency to 8.6% from 1.3%, due to high real yields, a weak currency, the chance of slow interest rate cuts, and stable global demand.

Fund Performance

For November, the Fund's Class A shares at NAV lost 1.99%, compared to -3.64% in the local-currency index (GBI-EM Index), and -1.70% in the hard-currency index (EMBI Index). The Fund's biggest winners in November were Argentina and Portugal (hard-currency), and Nigeria (local-currency). The Fund's biggest losers were Indonesia, Mexico, and Colombia (local-currency).

The market's best performers during the past month were Argentina, Senegal, and Belize in hard currency, and Nigeria, China, and Mexico in local currency. The markets' worst performers of the past month were Venezuela, Uruguay, and Indonesia in hard-currency, and Indonesia, Philippines, and Brazil in local-currency.

Price, Interest and Currency ("FX") Components of Fund Returns by Country for November 2013



Source: Van Eck Global; Bloomberg. Data of November 30, 2013.

This chart is for illustrative purposes only. Historical information is not indicative of future results; current data may differ from data quoted.

Average Annual Total Returns (%) as of November 30, 2013

	1 Mo*	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	-1.99	-5.21	-3.15	3.76
Class A: Maximum 5.75% load	-7.67	-10.64	-8.74	-0.55
GBI-EM Index	-3.64	-8.47	-6.50	--
EMBI Index	-1.70	-5.73	-5.06	--

Average Annual Total Returns (%) as of September 30, 2013

	1 Mo*	YTD	1 Yr	Life
Class A: NAV (Inception 7/9/12)	3.41	-6.51	-0.80	3.11
Class A: Maximum 5.75% load	-2.57	-11.86	-6.48	-1.73
GBI-EM Index	4.40	-7.56	-3.74	--
EMBI Index	2.61	-6.67	-4.06	--

[1]Baa3 is the lowest investment-grade rating issues by Moody's. Baa3 is one notch above non-investment grade, or speculative debt.

Expenses: Class A: Gross 1.67%; Net 1.25%. Expenses are capped contractually until 05/01/14 at 1.25% for Class A. Caps exclude certain expenses, such as interest. The tables above present past performance which is no guarantee of future results and which may be lower or higher than current performance. Returns reflect applicable fee waivers and/or expense reimbursements. Had the Fund incurred all expenses and fees, investment returns would have been reduced. Investment returns and Fund share values will fluctuate so that investor's shares, when redeemed, may be worth more or less than their original cost. Fund returns assume that dividends and capital gains distributions have been reinvested in the Fund at NAV. Index returns assume that dividends of the Index constituents in the Index have been reinvested.

Please note that the information herein represents the opinion of the portfolio manager and these opinions may change at any time and from time to time.

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Data Source: Van Eck Research, Factset. All portfolio weightings and statements herein as of November 30, 2013.

Emerging Markets Hard Currency Bonds refers to bonds denominated in currencies that are generally widely accepted around the world (such as the US Dollar, Euro or Yen). **Emerging Markets Local Currency Bonds** are bonds denominated in the local currency of the issuer. **Emerging Markets Sovereign Bonds** are bonds issued by national governments of emerging countries in order to finance a country's growth. **Emerging Markets Quasi-Sovereign Bonds** are bonds issued by corporations domiciled in emerging countries that are either 100% government owned or whose debts are 100% government guaranteed. **Emerging Markets Corporate Bonds** are bonds issued by non-government owned corporations that are domiciled in emerging countries. A **Supranational** is an international organization, or union, whose members transcend national boundaries and share in the decision-making. Examples of supranationals are: World Bank, IMF, World Trade Organization.

Any indices listed are unmanaged indices 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. An index's performance is not illustrative of the Fund's performance. Indices are not securities in which investments can be made. The J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM) tracks local currency bonds issued by Emerging Markets governments. The index spans over 15 countries. The J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI) 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 Barclays U.S. Aggregate Bond Index is a market capitalization-weighted index representing most U.S. traded investment grade bonds. The index comprises government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturity of the bonds in the index are over one year.

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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 emerging markets securities. 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, market, credit, management and the risk that a position could not be closed when most advantageous. The Fund may also be subject to credit risk, interest rate risk, sovereign debt risk, tax risk, non-diversification risk and risks associated with non-investment grade securities. Please see the prospectus and summary prospectus for information on these and other risk considerations.

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