

Another DM Crisis, With EM The Safe Haven?



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Another developed market, Japan, has spurred global market jitters, reinforcing our mantra that DM is the new EM.

The VanEck Emerging Markets Bond Fund was up 1.98% in July, compared to up 2.07% 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 is up 2.39%, outperforming its benchmark, which is up 1.34%, the ICE BofA Global Broad Market Index, which was down 0.51% and the FTSE 10-year Treasury benchmark, which was up 0.84%. The decades-old story of emerging market (EM) bonds outperforming developed markets (DM) continues. During July, the fund increased local currency exposure in Mexico, covering a big underweight in Mexico local after it sold off. The fund was also underweight Brazil local, which also got sold off in July, and the fund is looking to establish a tactical long position there as well, likely during August. We continue to like duration as well as selected EMFX, now including the high beta currencies following their weakness (Mexico, Brazil). Carry is 7.5%, yield to worst (YTW) is 8.8%, duration is 7.0, and local makes up around 55% of exposure.

Average Annual Total Returns* (%) (In USD)

Month End as of July 31, 2024	1 Month	3 Month	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 07/09/12)	1.85	3.86	2.08	5.17	0.19	2.23	1.06
Class A: Maximum 5.75% load	-4.00	-2.11	-3.79	-0.88	-1.77	1.03	0.47
Class I: NAV (Inception 07/09/12)	1.86	3.99	2.42	5.49	0.54	2.58	1.39
Class Y: NAV (Inception 07/09/12)	1.98	4.01	2.39	5.41	0.42	2.52	1.32
50% GBI-EM/50% EMBI	2.07	3.58	1.34	4.58	-2.22	-0.41	1.15

Quarter End as of June 30, 2024	1 Month	3 Month	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 07/09/12)	0.26	0.52	0.22	4.94	-0.76	2.28	0.88
Class A: Maximum 5.75% load	-5.51	-5.26	-5.54	-1.10	-2.70	1.08	0.29
Class I: NAV (Inception 07/09/12)	0.43	0.58	0.55	5.26	-0.40	2.60	1.21
Class Y: NAV (Inception 07/09/12)	0.19	0.45	0.40	5.03	-0.51	2.51	1.12
50% GBI-EM/50% EMBI	-0.23	-0.66	-0.72	4.91	-2.88	-0.61	0.91

* Returns less than one year are not annualized.

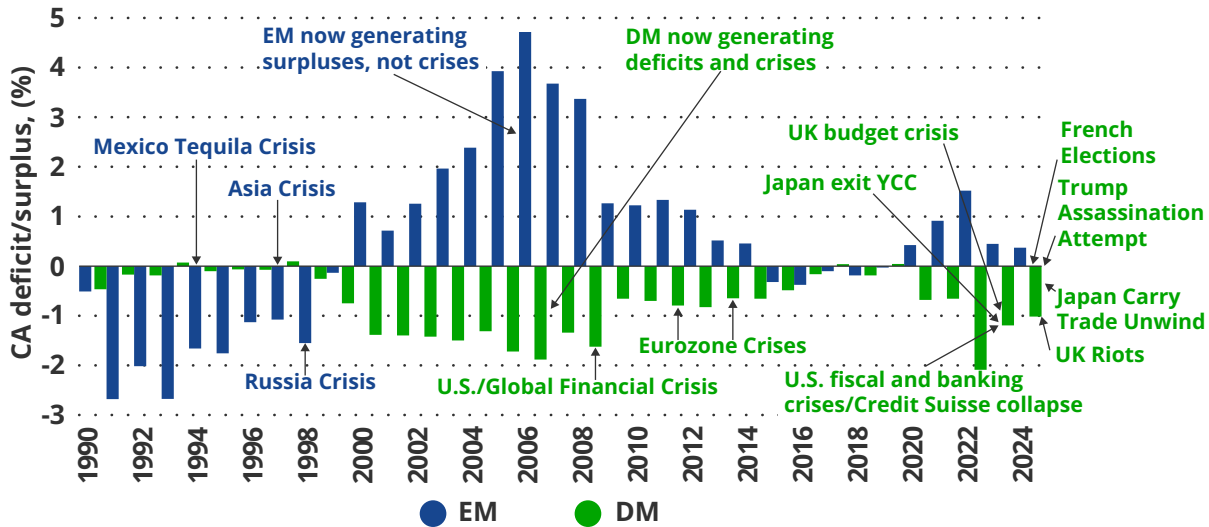
Expenses: Class A: Gross 2.55%, Net 1.22%; Class I: Gross 2.51%, Net 0.87%; Class Y: Gross 2.91%, Net 0.97%. Expenses are capped contractually until 05/01/24 at 1.25% for Class A, 0.95% for Class I, 1.00% for Class Y. Caps excluding acquired fund fees and expenses, interest, trading, dividends, and interest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

Yet again, a DM (this time, Japan) is blowing up global markets. An over-indebted DM that led the world in money experimentation ended up with...hiking rates into an economic downturn! This follows market-unsettling elections in France, riots in the UK under a new PM, and extreme political uncertainty in the U.S. And of course, geopolitics. Our mantra remains that DM is the new EM. More on Japan below. We update our stylized "history of the world" chart below. What is noteworthy is the number of accumulating DM crises, consistent with our longstanding "fiscal dominance" thesis for some DMs.

Exhibit 1 – Dissaving DM Vulnerable to Crises, High-Saving EM Not Vulnerable



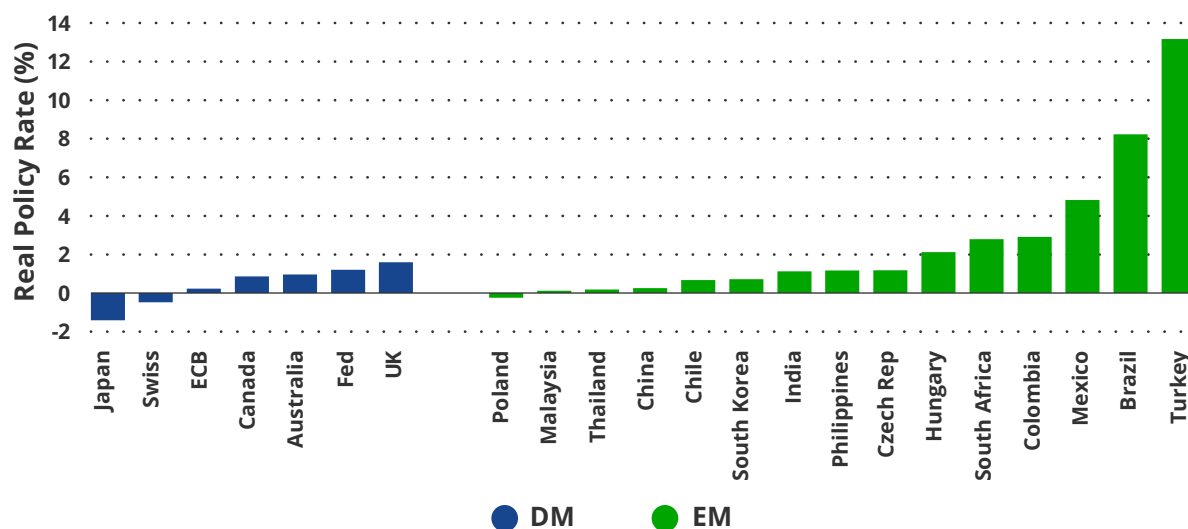
Source: Bloomberg, LP as of December 2023

This uncertain environment is a recipe for an ongoing U.S. rates rally. As we've been noting, the U.S.' surprising demand strength up until now has been supported by asset prices, which are now faltering. We can't see how consumption and investment decisions by individuals and corporations won't be dampened profoundly, due to the uncertainties we note above. Oh, and remember how the market just positioned as if U.S. politics were supposed to get U.S. rates higher? We remain attracted to duration as we highlighted in our last several monthly commentaries. Initially, the argument was that the market had dramatically reduced its implied cuts from 6 to 2, and we thought that was a "clearing" moment, plus some other reasons. What about now? We have a pretty simple view. First, the clearest implication of the Japanese yen (JPY) kerfuffle is that pressure on the Fed to cut has increased (more on this argument when we discuss Japan later). Second, the 5-year yield is now below the 10-year's yield! Roll-down could become a big theme next year, as longer-dated bonds get anchored by this fact, maybe eventually anchored by 2s, who knows. It's a more serious version, institutional version of the "those T-bill rates won't exist to get you through the next few years" argument. Third, we think the market is digesting "Trump trades" too fully, with a unanimous assumption of higher long-term rates and detailed, confident analyses of uncertain election outcomes and vague policy prescriptions. Maybe, but maybe it's way too early and policy way too uncertain as well as contradictory to be betting on politics right now. We continue to choose to focus on the data and markets' reactions to the July 12 U.S. CPI report re-affirms this focus, we think. That report opened the door to the subsequent rally in duration and even the now-famous "rotation" into small caps! Our view is that that theme of data-driven support for stable or lower rates is intact until we see or that it isn't or gets priced. Also remember that the surprising attenuation of demand in the U.S. appears to have been driven by the portfolio balance channel (the so-called "wealth effect"), injecting a potentially self-reinforcing dynamic to selloffs in stocks. Our only new concern is that the above could be written, and thus our view liking duration might not be as unusual as it was last quarter. However, we think the "Trump trade" distractions interrupted a still-ongoing data-driven process, basically.

Before we move away from rates, we should highlight a key question surrounding declining rates – will they be driven by a soft landing or something harder? We don't know. We do have a strong view that the profound political and geopolitical uncertainty confronting many developed markets *has to* have an adverse impact on individual and corporate consumption and investment behavior. It simply must. There is no way that the German Finance Ministry is adjusting its budget to new political rallies (cutting defense allocations to Ukraine by half) and the global auto industry is absorbing the impact of possible changes to the green agenda on EV plans, and that's all there will be. After decades in EM observing the implications of collapsed trust in institutions as well as political uncertainty, we feel strongly that this is "a thing", as the kids say, and it's DM's turn. Acknowledging it is not celebrating it, by the way. We say that because we also observe an unnerving projection of politics onto asset-price predictions.

EM real rates are very high, going into a U.S. rate-cutting cycle. We won't elaborate on this because it's been the theme of so many of our pieces. But it remains glaring, and virtually every EM central bank in the world is awaiting the starting gun from the Fed (as are investors). So instead, we'll focus on our worries here. Other than obvious U.S. growth metrics (to show whether rates are going down, but growth is or isn't suffering along the way), we are sensitive to ROW growth given that we are an emerging markets fund – EM growth out- or under-performance will be a key determinant of asset prices, especially in local currency. Anyway, our point is that that is the more formal way in which we'll look at risks to “growth”, but U.S. data will obviously be viewed as an underlying driver. (The key counter to all of this self-doubt and worry about relative growth rates and our risk positions is China, in particular its cheap and strong currency which is the primary transmission mechanism between China and the EMs, which we discuss later.) These are worries over our core view that too many EMs have maintained real rates that are too high, for too long, and that the Fed cutting opens the doors to rallies in EM local currency bond markets.

Exhibit 2 – EM Real Rates Were Kept Too High, Now the Fed is Opening Door to Cuts



As of August 2024

Source: VanEck Research, Bloomberg LP

Does Japan have a plan, other than kicking the can? Yes – hike interest rates into a declining economy and ever-more-indebted government! Japan mattered this quarter. And not just because it remains a shining model for the bad state of over-indebted DM governments that co-opted their central banks, which are now paying the price. The one thing that always struck us about Japanese central bankers is that despite all the money experimentation, they do remember the textbooks and seem (or claim) to worry about “trust in bank notes” (a quote from one of my meetings years ago). So, they are hiking rates to compensate for the feared nominal interest-rate differential with the U.S. Too bad about the declining economy and over-indebted government! This is not sustainable and should be noted as other DMs will face the same eventual hard trade-offs (with the U.S. by far the least-dirty shirt of the DM bunch, despite its dirtying efforts with the extremely stimulative fiscal policy during low unemployment, underlining the risks of dollar rallies to which we are alert). For what it's worth, risks right this moment still seem to be to the downside in USD/JPY, the points above are to paint a picture of the basic context which is not good.

Here's the deal – get real. Our view is that the nominal rate-differential is too narrow a lens, and that the fiscal and central bank balance sheet adjustments are the bigger driver, long term. After all, if you want to find an unattractive interest-rate differential with the U.S. which *did not* result in currency and bond weakness, just look at China! So, what's our bottom line on this? Japan remains a good example of what's coming for many DMs. But, the concrete impact on EMs was largely temporary – JPY weakness encouraged carry trades in EMs, which get and got wash-outs when JPY rallies. The end. The bigger story of a challenged Japan hasn't gone away – did we tell you they're hiking into economic weakness and a heavily-indebted government? It really says it all. But the short-term hit to carry trades has likely disappeared for now. And China has been the key to insulating EMs, which we discuss next. *We can pan Japan's plan, as it's in a jam, but try as we might, there's no impact from it's plight.* For now. Even Korea (whose export mix overlaps with Japan's) has performed strongly, in no small part to...China.

China and CNY matter more than Japan and JPY, and thank goodness because CNY was a flight-to-safety currency during the yen carry trade wash-out. CNY stability anchors all Asian EMFX (witness the Malaysian ringgit's 5% rally during the JPY kerfuffle), if not more. But, China isn't rescuing global demand as it did following previous DM crises such as the global financial crisis (GFC) and the Covid lockdowns; like most EMs, ginning up markets or even GDP isn't the first reaction function that it often appears to be in DMs. CNY and Chinese government bonds (CGBs) were remarkably strong throughout all the risk events this year, despite an incredibly tight rate differential with the U.S. We have to emphasize a key observation – a simple nominal rate comparison isn't that useful! The *real* rate differential with the U.S. looks a lot different, in China's favor.

Our point is so simple and so unstated, we'll state it – persistently low inflation in China relative to its trading partners has meant that its real effective exchange rate has *cheapened* incredibly. We show the REER calculation using manufacturing inflation below. CNY is stable as well as cheap (so, literally, “risk/return”), in a sea of turmoil including “neighboring” Japan. This has insulated especially Asian local markets dramatically, a phenomenon we’ve now observed with you for over three years. A major portion of the EM debt market (EM Asia) continues to be a flight-to-safety “graduate”. That’s our story until there’s evidence it’s changing.

Exhibit 3 – China’s Low Inflation Has Led to Cheaper Real Effective Exchange Rates (REER) vs. USD



Source: BofA Global Research, Bloomberg, Japan Research Institute

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions in July were South Africa, Brazil, Thailand, Indonesia, and Mexico:

- We increased our local currency exposure in Brazil. Brazilian bonds sold off a lot after a series of unorthodox comments by President Lula about the fiscal policy stance and the central bank’s independence, but there are signs that the central bank’s new governor will be a credible official rather than a political appointee. The market might also be pricing in too many rate hikes in Brazil despite a fairly benign inflation outlook. In terms of our investment process, this improved the policy and technical test scores for the country.
- We also increased our hard currency sovereign exposure in Chile. The country should be expected to benefit from the additional stimulus signals in China after the 3rd Plenum and July’s Politburo meeting, which hinted at using “new policy instruments” to prop up growth – in addition to the recent changes in the monetary policy framework (using the 7-day reverse repo rate as the key policy rate) and surprising rate cuts. In terms of our investment process, this translates into the improved technical test score.
- Finally, we increased our local currency exposure in Colombia, where bonds got sold off on the back of another fiscal scare (and some unfortunate headlines by President Petro). However, there was no negative follow-through, and the 2025 budget still aims to respect the fiscal rule, which improved the policy test score for the country. We are mindful of risks though, including a lack of details about deficit financing, which might keep the market’s attention firmly on the spending side.
- We reduced our local currency exposure in Poland and Hungary. Geopolitical risks in the region can increase in the run up to the presidential elections in the U.S., as the market might price in alternative scenarios regarding President Trump 2.0 and the situation in Ukraine. In Hungary, there are additional complications associated with the country’s EU presidency. These factors worsened the policy test scores for both countries.

- We also reduced our hard currency sovereign exposure in the United Arab Emirates and Kuwait. These were lower-yielding funders for other opportunities. In addition, growth concerns in China and the U.S. might weigh on commodity prices, including oil, worsening technical test scores for both countries.
- Finally, we reduced our local currency exposure in Taiwan, hard currency sovereign exposure in El Salvador, and hard currency corporate and quasi-sovereign exposure in China. In China, authorities are aware of growth problems but sticking to the “drip” stimulus for now. There are indicators that the central government might allow using its balance sheet to address real estate turmoil, but until that happens, China’s policy test score will not be improving. The Taiwanese dollar is highly correlated with the Chinese renminbi, which might be affected by growth and geopolitical concerns. As regards El Salvador, we chose to take profits on our position, seeing limited upside.

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