March 2024

Cynical Bull – An Emerging Markets Debt Perspective

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> Fed rate cuts are coming, but moving too swiftly is a risk. We discuss the implications for emerging markets debt investors.

The VanEck Emerging Markets Bond Fund (the Fund) was up 0.2% in February in line with 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 outperforming its benchmark by around 30 basis points (bps). From a country perspective, Zambia and Ecuador were winners, Egypt (not owning it) was a loser. We increased exposure to local currency (due to increases in Brazil and the Philippines) and increased duration (via hard-currency bonds), in line with the market now pricing out a lot of the Fed's cuts. We end February with carry of 7.1%, yield to worst of 8.6%, duration of 5.5, and 50% of the Fund in local currency. Our biggest exposures are Brazil (local), Mexico (local and hard), Indonesia (local), Colombia (local), and Poland (local).

Average Annual Total Returns* (%) Month End as of February 29, 2024

	1 Month	3 Month	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 07/09/12)	0.07	2.88	-0.96	7.63	-0.60	2.86	1.57
Class A: Maximum 5.75% load	-5.69	-3.03	-6.66	1.44	-2.54	1.65	0.97
Class I: NAV (Inception 07/09/12)	0.06	2.99	-0.78	8.09	-0.26	3.18	1.88
Class Y: NAV (Inception 07/09/12)	0.25	2.99	-0.78	7.95	-0.33	3.12	1.81
50% GBI-EM/50% EMBI	0.20	2.86	-1.07	9.72	-2.45	0.28	1.52

Average Annual Total Returns* (%) Quarter End as of December 31, 2023

	1 Month	3 Month	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 07/09/12)	3.88	8.36	10.91	10.91	-0.79	4.14	1.80
Class A: Maximum 5.75% load	-2.09	2.13	4.53	4.53	-2.73	2.92	1.20
Class I: NAV (Inception 07/09/12)	3.81	8.43	10.97	10.97	-0.49	4.46	2.10
Class Y: NAV (Inception 07/09/12)	3.80	8.40	11.03	11.03	-0.57	4.39	2.03
50% GBI-EM/50% EMBI	3.97	8.63	11.95	11.95	-3.31	1.46	1.71

** 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.

Fun with the Fed Funicular. At the start of this year, the market priced in 6 Fed rate cuts in 2024, which has now reverted to back to the original consensus of 3 cuts. The market has been back and forth between 3 and 6 cuts, just like a funicular. One extremely simple implication for a funicular with only two stops is that, with the current station being 3 cuts, there's now room to go back to 6! A more interesting and complex implication, though, is that it takes time for this funicular to go back-and-forth, and while it is doing so, it increases the risk that inflation base-effects fade and nascent inflation and inflation expectations creep into Fed thinking (there are wars and tariffs about). The odds of a new stop on the funicular have logically risen. Moving forward, though, this also logically means that the odds of a mistaken rate cut (too early or too large) have risen. This is a bit cute and arguably time-inconsistent. Our only point is that while we see the upside risks to emerging markets (EM) currencies and EM bonds from the start of a Fed rate cutting cycle and are positioned appropriately, everyone else also sees it, so you have to be aware of each step on the path. Navigating the path is often the best one can do. Obviously, this all needs to fit into a formal process, but lucky us, Bayes exists for exactly these purposes. Rather than getting into Bayes, we'll say that we're worried about a contingent probability. Getting very specific, we think the implications are as follows:

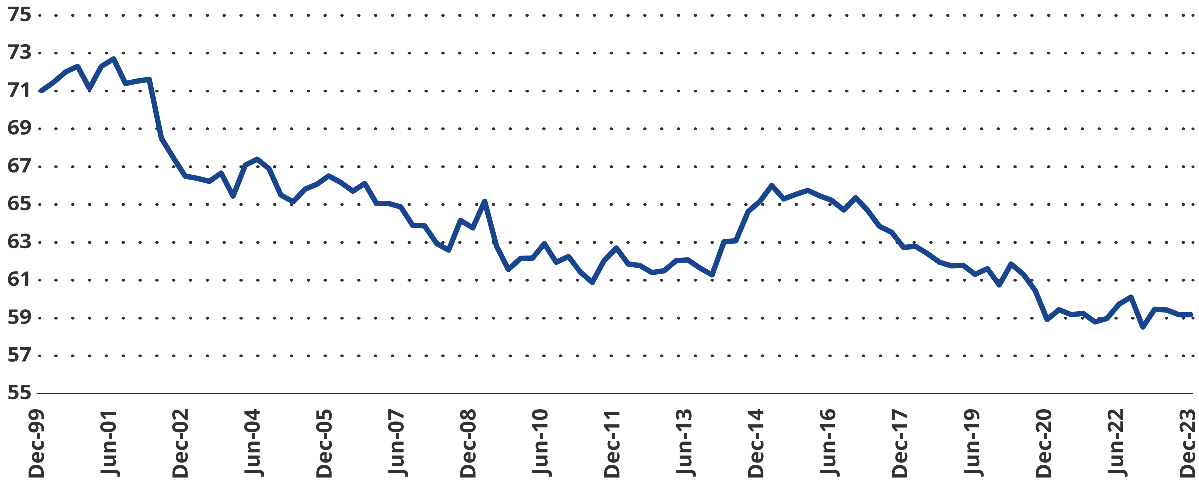
- The funicular should go back towards pricing 6 cuts if we assume nothing has changed (which is reasonable), we're just in a phase of pricing between 3 and 6 until the Fed actually starts cutting. Be patient.
- As the funicular goes back and forth over time, we're getting more stagflationary data. If it continues, this means that when the Fed easing cycle begins (whenever that is), yield curves could bear steepen soon after.
- This could be viewed as a rejection of Fed credibility, along with already record-high gold and bitcoin prices. That would represent a major new node/decision point for the year.
- This is a contingent scenario to help us prepare for a likely cutting cycle, not (yet) central case, and we explicitly state that the setback (the moment in the bullet above) is likely *not* the next "thing", or "node", rate cuts still are. Thus the "cynical bull".

Holy debt-debasement thesis-confirmation, Batman! We've been pounding the table for many years now about how "fiscal dominance" is driving *everything* in markets. We even finally wrote a stand-alone white paper on it. The thesis was that the dollar was entering new territory, which created even greater alpha opportunities in EM bonds. I assume it is obvious to our readers that new record prices for gold and bitcoin smack of debt-debasement, too, also noted in the piece. It's on, and EM debt has winners in the form of government bonds with high real yields backed by strong fiscal policy. It's not just gold and bitcoin which are winners! Central banks are not just buying gold, they are buying EM local-currency government bonds (wouldn't you, especially if the alternative was lower-yielding Treasuries?). By the way, did you know that the CBO projects no recession for the next 10 years and assumes 10-year Treasuries will have lower yields than currently?

Still not allowed to talk at cocktail parties. War and politics are important facts that markets try to ignore. This is wrong – these are analyzable events for which there may be appropriate portfolio responses. You need a central case, but you also need to do scenario analysis, whether you like the stories or not. War is inflationary, and U.S. politics look likely to generate inflation risks. You may not get joy discussing these at a cocktail party, but markets don't ignore reality. The conclusions are often simple and easily optimized. It just takes courage, not brains. For example, such a concern as ours above translates into caution on duration, clearly, and ours is currently right on top of our benchmark's duration. In addition, Chinese corporate bonds are highly illiquid and thus subject to top-down geopolitical risk headlines…so we've largely taken profit on these this past month. These are random examples, but the point is that rarely do major portfolio constraints arise from these scenarios, just challenges and opportunities. Anyway, our key point on geopolitics remains that is the developed market (DM) economies that are suffering from war, while many EMs are winners because of commodity exports, low debt, independent central banks that pay high real rates, and good economic structure. EM also doesn't sanction each other's savings, making their bonds that much safer. Other central banks noticed and are putting EM local currency bonds on their balance sheets (as with gold), as we noted in many of our previous commentaries. U.S. politics are an even more sensitive topic at cocktail parties, but last I checked tariffs are an inflationary tax, and last I checked both parties were essentially out-doing each other on this front. The election is this year; there's no reason to be "surprised" when those telegraphed outcomes materialize.

Exhibit 1 – Central Banks Hold Fewer Treasuries

Foreign Exchange Holdings in U.S. Dollars, % of allocated reserves



Source: Bloomberg LP; Data as of December 2023

Exposure Types and Significant Changes

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

- We increased our local currency exposure in Brazil and the Philippines. In Brazil, we were attracted by very high real rates (=attractive valuations), which make the country much less dependent on the Fed's rate cycle, as well as by a steady (and moderate) pace of rate cuts against the backdrop of on-going disinflation. A key risk in Brazil is fiscal underperformance, but other factors improved the policy and technical test scores for the country. The Philippine bond that we added were attractively valued, while the central bank is doing a great job managing the currency's volatility and can potentially have room for rate cuts in H2.

- We also increased our hard currency sovereign exposure in Kenya, Angola, and Gabon, and our local currency exposure in Kenya. Kenya's new bond addressed the forthcoming 2024 Eurobond maturity and was attractively priced. The central bank let the currency adjust in nominal terms, reducing pressure on international reserves, while hiking the policy rate. This improved the policy test score for the country. Gabon has just completed its Article IV talks with the IMF, which praised authorities' initial efforts to reform the economy, despite numerous challenges. In terms of our investment process, this improved the policy test score for the country.

- Finally, we increased our hard currency sovereign exposure in Ecuador and Qatar. There is a lot of optimism about Ecuador's reforms (including just approved tax reform and the VAT rate hike), which improve an IMF deal prospects and the policy text score for the country. Qatar continues to benefit from strong technical (such as a lack of longer-term issuance in the rest of the region), which supports the technical test score for the country.

- We reduced our local currency exposure in Mexico and Malaysia. The latter's valuations look less attractive vs. other options, hence the worsening technical test score. Mexico's central bank might be pivoting to the dovish side prematurely against the backdrop of slower "last mile" disinflation and the pre-election spending, especially if the U.S. Federal Reserve stays on hold for longer.

- We also reduced our hard currency corporate exposure in Turkey and China, as well as local exposure in Turkey. In Turkey, the decision to re-tap the corporate bond market within four months of the original issue sent a disappointing signal from the company's management. We also decided to take profits on the inflation-linked bond as the new governor might be even more hawkish than his predecessor, resulting in faster disinflation down the road. In terms of our investment process, this worsened the policy test score for that particular bond. China's lack of clarity regarding the resolution of real estate developers' debt remains a major headwind – both for GDP growth in general and the housing sector specifically – undermining the policy and economic test scores for the country.

- Finally, we reduced our local currency exposure in Uruguay, Sri Lanka, and South Korea. The common theme here is that local valuations no longer look particularly attractive, including Sri Lanka's short-end T-bills. In terms of our investment process, this worsened the technical test score for these countries.

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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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J.P. Morgan GBI-EM Global Diversified Index tracks local currency denominated EM government debt. The index weighting methodology limits the weight of countries with larger debt stocks, with a maximum of 10%.

J.P. Morgan EMBI Global Diversified Index is comprised of U.S. dollar-denominated Brady bonds, Eurobonds, and traded loans issued by emerging markets sovereign and quasi-sovereign entities. The index weighting methodology limits the weight of countries with larger debt stocks.

ICE BofA U.S. Treasury Index racks the performance of EUR denominated sovereign debt publicly issued by the German government in the German domestic or eurobond market.

ICE BofA German Government Index tracks the performance of EUR denominated sovereign debt publicly issued by the German government in the German domestic or eurobond market.

ICE BofA Global Broad Market Index tracks the performance of investment grade debt publicly issued in the major domestic and eurobond markets, including sovereign, quasi-government, corporate, securitized and collateralized securities.

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