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EM Bonds Guideposts for 2024

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> The economic backdrop appears supportive for emerging markets bonds headed into 2024. In this blog, we discuss five guideposts that are all largely supportive for the asset class.

In November, the **VanEck Emerging Markets Bond Fund** was up 5.83%, compared to 5.47% 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). China (corporate exposure in hard currency) was the big winner for the month, as were Brazil, Mexico, and Colombia (all in local currency). We've made few changes. Our duration remains near our benchmark's, having been very low through most of 2023. We end November with carry of 7.4%, yield to worst of 9.4%, duration of 5.7, and 50% of the fund in local currency. Our biggest exposures are Mexico (local and hard), China (local and hard), South Africa (local and hard), Brazil (local and hard), and Colombia (local and hard).

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

	1 Month†	3 Month†	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 07/09/12)	5.83	1.93	6.76	9.78	-0.97	3.43	1.46
Class A: Maximum 5.75% load	-0.25	-3.93	0.62	3.46	-2.90	2.21	0.87
Class I: NAV (Inception 07/09/12)	5.78	1.92	6.90	10.03	-0.65	3.76	1.78
Class Y: NAV (Inception 07/09/12)	5.76	1.89	6.97	9.98	-0.72	3.69	1.72
50% GBI-EM/50% EMBI	5.47	1.37	7.68	9.02	-3.71	0.94	1.31

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 1.22%; 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.*

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1. **The Fed is likely to cut its policy rate in 2024, supporting EM local currency debt.** Fed Funds are pricing in greater-than-50% odds of a rate cut in March, and over 70% odds of cuts in subsequent meetings. By itself, this reduces support for the U.S. dollar against EM currencies, and lasts through 2024. This looks to be a key fact of 2024, and currencies are the most direct winner, to our eye. Our mantra remains "the turn in policy rates is not the turn in risk", and we advise against chasing long-duration assets on the assumption that long-end rates will follow suit with a high degree of confidence. The mix of quantitative tightening plus 6+% fiscal deficits from the U.S. (and rising ones in China) plus the rising perceived risk of central bank holdings of U.S. Treasuries generate a cautious stance on duration, in our opinion. As we've noted repeatedly in our writing, EM central banks have by-and-large maintained much higher real policy rates, and their bond markets exhibit steepness (not the inversion of the U.S. yield curve). This sets EM bonds up very positively not just for currency strength, but for rallies on the longer end of their curves even if the U.S. duration story remains indeterminate. One final point: EM currency strength tends to be self-fulfilling. Stronger EM currencies will further depress inflation, making policy and market rates that much higher in real terms. This boost to currencies can support declining yields, even if U.S. yields aren't cooperating. This is a scenario very few are anticipating, we think.

2. **EM debt should perform very well in a "soft landing" scenario, but also in "hard landing" scenarios if they are "stagflationary".** The nature of any U.S. recession will clearly be an important determinant of asset price outcomes. As we imply above, the only clear conclusion one can draw from any "landing" is that the U.S. policy rate will decline. Further out the curve, we are less certain. Popular discourse posits a "soft" and "hard" landing, which is a useful framework. A "soft" landing, in which rates decline but due to a gentle and non-inflationary decline in demand, is an ideal scenario for emerging markets. Global demand is acceptable and rates and EM currencies should rally. This scenario is not much-disputed (rightly so), other than the argument that it might already be priced in (which we'll leave aside in this monthly letter, other than saying offshore exposure to emerging markets is low historically). What about a "hard" landing, though, in which final global demand falls more sharply? Well, two things should be said about that scenario. First, the U.S. policy rate is likely to fall more sharply in that scenario, maintaining the support for EM currencies. Second, if any coming recession is "stagflationary" and characterized by sticky and elevated prices for less demand-elastic commodities, emerging markets perform well in that scenario, too, in our view. EM debt markets are filled with commodity exporters (unlike EM equities, which though they produce external surpluses they are not due to commodity exports). The new geopolitical configuration, in which key commodity producers (now including Russia, Saudi Arabia, and Iran) are increasingly aligned against the key DM importers, would support the odds of a "stagflation" scenario, as would ongoing Chinese commodity-intensive recover policy for its property sector.

3. **No quick policy "fixes" in China.** Property prices are too high, but also too integrated in Chinese wealth, production, and social health to adjust without control. Targeted policies encouraging consolidation in the property sector, coupled with bank and official support for lending and debt workouts are happening. Housing is becoming central to social policy, too, with a one-trillion yuan urban housing project that includes conversion of under-construction units to social housing. A "white list" of property companies that is guiding the market as to who will operate in the future has been established. Even fiscal policy has been activated with an additional 0.8% of GDP in spending announced recently. But, the bulk of the work in the property sector will depend on structural reform. And, previous attempts didn't see great traction, so implementation remains a risk. Moreover, the adjustment in real estate prices required to restore equilibrium is monumental, so a decade should be a baseline expectation for that timeline. What does this mean to us? We still see no value in Chinese local-currency government bonds (rates are close to U.S. rates, true in much of Asia). But we did gain exposure to Chinese corporate bonds *after* this year's collapse in bond prices (a follow-on from last year's collapse, which we also bought and sold). So, we're viewing the situation as an opportunity, but one where it's all about the details, upcoming catalysts (like debt workouts and new lending), with no big takeaways for broader markets. Other than that the policies we are seeing are commodities-intensive. And, that our opportunism is strengthened by our observation that it is almost impossible to find investors with a positive attitude toward anything Chinese.

4. **Commodities supply risks contained, not eliminated.** The decline in oil prices following Hamas' attack on Israel on October 7th gives an impression that geopolitical risks are overstated. Our take is different. We see the lack of a bullish response in oil markets as a reflection of major and regional powers' agreement to prevent expansion of the conflict. This includes the U.S.'s Sunni allies as well as Iran. If that's the correct framing, then the key question is how long regional escalation can be prevented. We're not sure, consistent with the great uncertainty that characterizes popular media descriptions. Our point, therefore, is that what the oil market is pricing is a lack of regional escalation, but whether that containment continues is a bit of a toss-up. We'll use uranium as an example of our framework in action. For years, we noted that as the producer of 40% of the world's uranium, Kazakhstan was in a strong position and uranium would be highly subject to geopolitical risk. As it turned out, France's main supplier, Niger, was one of several west African nations subjected to coups. France goes shopping in Kazakhstan as a result, with uranium prices up 50% in the early part of this year. Our point is that one can focus on which particular termite will bring a chair down, or one can simply notice that there are termites and avoid the chair altogether. We prefer the latter framing. We did not predict a spike in uranium prices in March of 2023 following political events in Africa; instead, we simply said there are a lot of risks pointing in the direction of supply risk and that we don't know which particular bite of the termite makes it obvious. Geopolitical termites are present, be aware. The biggest challenge to this view is global demand – any sharp fall should be expected to reduce commodities demand.

5. **Fiscal dominance will remain a key market driver. Over-indebted economies (mostly in the developed markets) will continue to drive market crises, and EM bond markets will continue to weather these crises smoothly.** Do you remember the two fiscal crises and one banking crisis in the U.S. this year? How about the budget crisis in the UK that led to a 15% gilt bill being printed and the resignation of a Prime Minister after just 90 days? Do you remember the struggles in the Japanese Government Bond market as the Bank of Japan exited its experimental monetary policies by allowing interest rates to rise (and the currency to weaken)? What do they have in common? They are all DM countries suffering from excess debt, or "fiscal dominance". And their bond markets were the biggest sufferers this year as a result. At its most basic level, in situations of "fiscal dominance", central banks can't credibly target inflation (as government bankruptcy will constrain rate hikes). This initial condition, and the absence of any likely solutions (we note above U.S. and Chinese fiscal deficits appear large indefinitely) is an additional reason to be concerned about duration, at least. Whether duration sell offs are attributed to credit risk or to the term premium might lag reality, but to some extent reflect the same diminution in perceived U.S. credit quality.

Exposure Types and Significant Changes

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

- We increased our local currency and hard currency sovereign exposure in South Africa and Chile. A prospect of China's (eventual) rebound improves the outlook for commodity prices in both countries, strengthening their technical test scores. South Africa's disinflation and the end of the hiking cycle, as well as realistic fiscal plans gave an extra boost to the country's policy test score. In Chile, it looks like most of negative developments are already priced in, whereas the central bank is getting less dovish having frontloaded a lot of rate cuts. In addition, the central bank also suspended its FX buying program, which should improve support for the Chilean peso.
- We also increased our local currency exposure in Mexico and the Czech Republic. Mexico's increase mostly reflected the favorable price action, but we also must note the hawkish central bank and the stronger than expected growth outlook. Bonds' valuations also remain attractive against this backdrop, improving the technical test score for the country. The Czech National Bank is also on the hawkish side, albeit we think it is getting closer to policy easing as economic growth remains very soft.
- Finally, we increased our hard currency corporate exposure in China, as well as hard currency sovereign exposure in Qatar, Mongolia, and Cote d'Ivoire. China's position reflected significant price appreciation, as authorities announced new measures to support real estate developers. We also added one particular bond following the announcement that a credible government official was promoted to a vice chairman position. In terms of our investment process, this improved the policy test score for the country. As regards Qatar, the country's geopolitical importance is an asset given the latest spike in the Middle East turbulence, and it can also benefit from higher oil prices. Higher commodity prices – in this case copper – is a boost to Mongolian assets. In addition, the country might be nearing a rating upgrade, which would reflect its prudent debt management, decreasing dependence on energy imports, and the rapid development of tourism industry. All these factors improved Mongolia's policy, technical, and economic test scores. Cote d'Ivoire's bonds have good valuations, and there is potential for further spread compression on a soft landing/U.S. Fed is done scenario.
- We reduced our hard currency sovereign and quasi-sovereign exposure in Argentina, and hard currency corporate exposure in Indonesia. Our move in Argentina reflects the post-election uncertainty about the new policy agenda, the speed of policy adjustment, and the transition period which can worsen the macro implosion, making it more difficult to fix the existing problems. In terms of our investment process, this worsened the policy test score for Argentina. In Indonesia, we participated in a tender and took profits on one of our corporate positions, hoping to employ the proceeds elsewhere.
- We also reduced our local currency exposure in Brazil and Romania. Brazil's move was due to portfolio rebalancing, as well as the fact that the position outperformed a lot. In Romania, there is a great deal of uncertainty surrounding the new pension bill, which might affect the fiscal outcomes, bond issuance, and potential EU disbursements. In terms of our investment process, this worsened the policy test score for the country.
- Finally, we reduced our hard currency sovereign exposure in Jordan and local currency exposure in Sri Lanka. Sri Lanka's debt restructuring remains noisy, with more concerns about transparency from bondholders, which worsens the policy test score for the country. Jordan's economy is very exposed to the Middle East turmoil, especially as the conflict's resolution remains elusive, worsening the technical and economic test scores for the country.

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