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Fed Cuts Are Positive For EM Local Bonds

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> Emerging markets have held real rates high for too long. Will the Fed's rate cutting regime signal a change?

The **VanEck Emerging Markets Bond Fund** was up 2.50% in August, compared to 2.70% for its benchmark, the 50% J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM) and 50% J.P. Morgan Emerging Markets Bond Index (EMBI). Year to date, the fund is up 4.63%, compared to up 4.06% for its benchmark, and compared to the ICE BofA Broad Market Index (Global Agg), which was up 1.74%. The decades-old story of emerging markets (EM) bonds outperforming developed markets (DM) continues. During August, the fund continued increasing local currency exposure in Mexico, covering a big underweight in Mexico local that existed most of this year. We are also considering rotating into Brazil, Chile, and Poland local currency, using our Asian local exposure as a funder due to its incredible outperformance. We continue to like duration, and we have our maximum allocation allowed to local currency, now including the high betas following their weakness (Mexico, Chile), while maintaining our overweight in South Africa local. South Africa was one of our only high-beta local exposures throughout this year, and performance and fundamentals cooperated, so no change there. We held underweights in Brazil and Mexico, though, and only initiated these positions after their weak performance (some of which continued in August). Carry is 7.5%, yield to worst is 8.6%, duration is 7.2 and local makes up around 58.1% of exposure.

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

As of August 31, 2024	1 Month	3 Month	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 07/09/12)	2.50	4.67	4.63	10.79	0.71	3.98	1.30
Class A: Maximum 5.75% load	-3.39	-1.35	-1.38	4.42	-1.26	2.76	0.70
Class I: NAV (Inception 07/09/12)	2.53	4.89	5.02	11.1	1.06	4.31	1.62
Class Y: NAV (Inception 07/09/12)	2.45	4.69	4.90	10.94	0.97	4.24	1.54
50% GBI-EM/50% EMBI	2.70	4.58	4.08	9.69	-1.63	0.31	1.36

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.

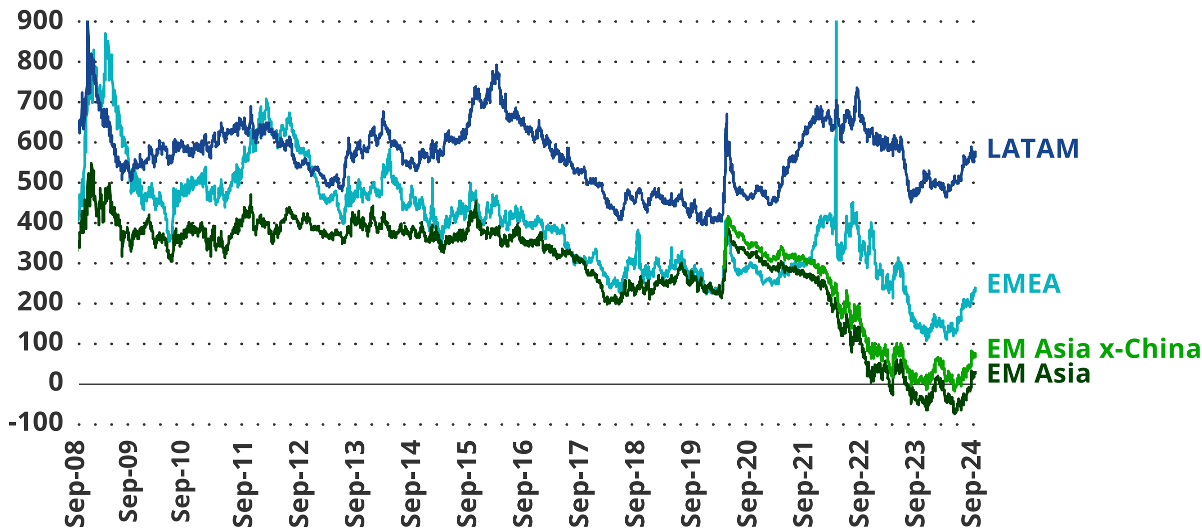
The performance data quoted represents past performance. Past performance is not a guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance may be lower 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.

U.S. rate cuts are in focus. This is the moment – EMs have been maintaining high real rates arguably for too long, and are simply waiting for the cue from the Fed. The key is, of course, whether rate cuts are inaugurating a soft or hard landing. A hard landing would be adverse for credit spreads and emerging markets currencies (EMFX), arguably. We don't know whether the landing will be hard or soft. But, we think there's no evidence yet of a hard landing, so we are sticking with the data-focused view we've maintained this year. We also note that 2s/5s became less inverted, the nominal steepness of which would be the next element of the bullish rolldown thesis we've discussed in other monthlies. 2s/10s are close to steep, 5s/10s steepness, in our opinion, would "lock-in" the rolldown argument for duration (namely that in forecasting returns, the roll down the curve generates great confidence). One last point: rate cuts could flip the stock/bond correlation, boosting demand for bonds and bond duration. Low inflation and inflation volatility point to a change in the classic stock/bond correlation that is behind the 60/40 "rule". If bonds now go up when stocks go down, that must generate greater interest in bonds but particularly bond duration. UBS calculates that when inflation is at 2.6%, the stock/bond correlation flips. Anyway, the setup remains that EMs have maintained high real rates for too long, arguably, and Fed cuts open the door to rate and FX rallies in EM. Note also that Chinese private and government-related ownership of U.S. dollars (USD) is significant (some estimate$1tn), and therefore the idea that lower rates in the U.S. could see them sell USD and move onshore to China is real. Exhibits 1 and 2 below quantifies the bigger picture. Basically, EM Asia has been so orthodox for so long that its borrowing rates are the same as that of the United States. This was the famous flight-to-quality to Asia we've been harping on about for the past few years. That seems established to us. But, look at Latin America (LATAM) and EMEA which still have big real yield premia over DM. The Asia rally confirms the thesis, and LATAM and EMEA now have more relative value as a result (later we note that we have taken profit on some Asia exposure and are moving into higher-beta LATAM and EMEA).

Exhibit 1 - Asia EM Rallied During Risky Last 4 Years

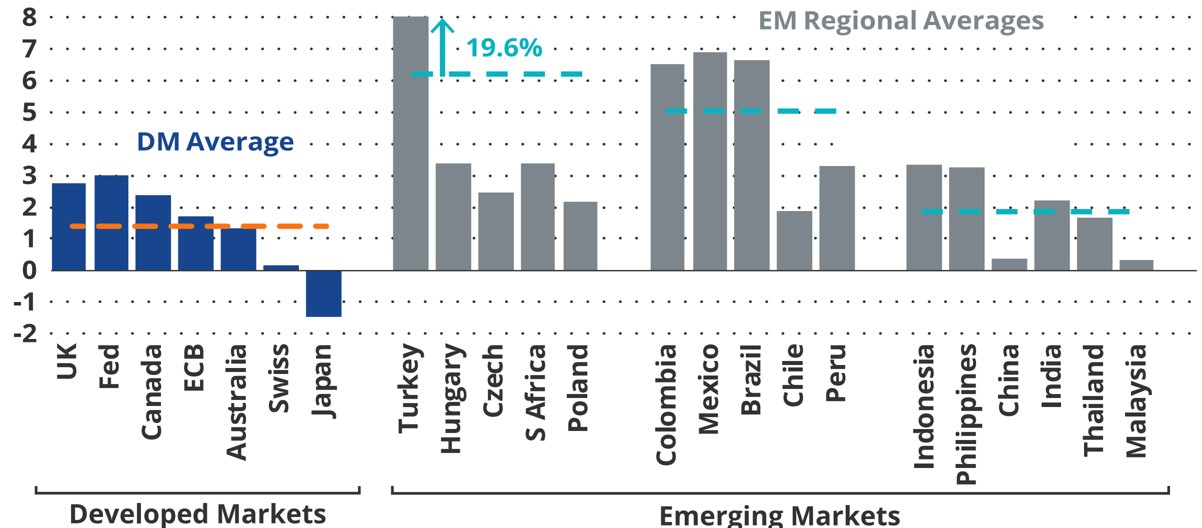
EM Regions - GBI-EM/5Y UST Yield Differentials, bps



Source: VanEck Research, Bloomberg LP. Data as of August 2024

Exhibit 2 – LATAM and EMEA Still Have High Real Rates

Real Policy Rates in EM and DM (%)



Source: VanEck Research, Bloomberg LP. Data as of August 2024.

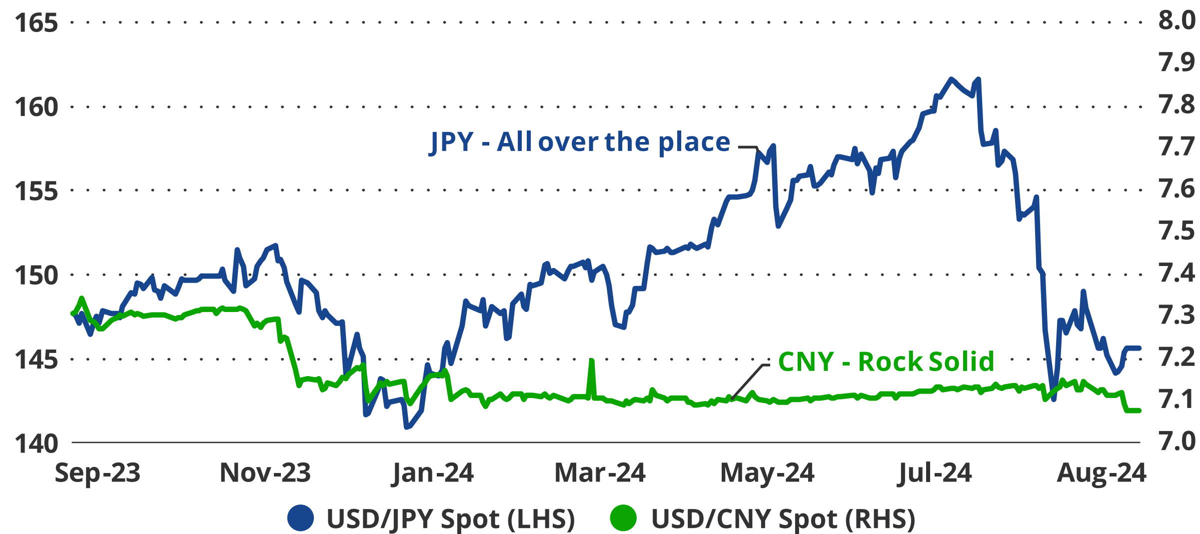
Another month, another DM crisis brewing? Mario Draghi (remember him?) called for the issuance of common bonds by the European Union (EU) and threw some big numbers (800 bn EUR) at the amount of financing required to get Europe growing again. The German Finance Minister took three hours to respond with a "nein". It's a bad setup. And adding to the contradictions, Draghi lamented the absence of tech innovation… and the next day EU Commissioner Vestager announces record fines on Apple and Google. As everyone hopefully knows, there remain profound contradictions in the EU and Euro Zone's (EZ) policy framework that are unresolved. The EZ has one money (EUR), but many fiscal policies and many financial systems. The fiscal inconsistency was supposed to be checked by the Maastricht criteria, which were basically thrown out of the window the moment any important (e.g., France) country gets into trouble. Financial systems are heterogeneous, so they are obviously leveraging the monetary system in inconsistent ways as well. Normally, these basic issues are sorted before a currency zone is set up. In Europe, crisis seems to be the only catalyst for reform.

Unfortunately, a key looming risk is direct NATO-Russia war. We think market participants are reluctant to think about this scenario, as many consider it is impossible to trade, which could be true. In any case, it appears to us that long-range attacks into Russian territory by Ukraine have been given a "green light". It also appears to us that there is great risk in this development, and we think that further escalation will see Russian counter attacks outside of Ukraine. We say this just to acknowledge it. The clearest implication, though, is lower U.S. rates and an even-more cooperative Fed. Spreads could widen and there could be a knee-jerk USD rally. Look what happened when another DM, Japan, was rocking the world this summer. China's renminbi (CNY) was rock solid, insulating Asian EM as well as all EMFX to a big extent. Also consider what would happen to commodity prices in this environment, keeping in mind that LATAM are largely commodity exporters. We wanted to flush some of these things out before anything happens, so our clients have an outline of our thinking and reaction function.

Speaking of the significant political and policy risks in DM, U.S. elections are coming into focus. Our simple scenarios are that a Republican sweep is likely a challenge for EM due to the risk of a USD rally as tariffs and unfettered fiscal policy get priced. If the Democrats control either the House (the Senate seems out of reach) or the White House, then we see a more unequivocally positive environment - fiscal will be fettered and policies behind a potential USD rally (such as tariffs) get watered or negotiated down. Our main view is that it is still too early, given not just election uncertainty (including post-election), but the risk surrounding the reality of policy changes, or that positions become negotiations. Tariffs are already somewhat old news, too. One thing we suspect is that a Trump Administration 2.0 would not simply be a repeat of Trump 1.0 in which Mexico was the new and clear target. China is more in the crosshairs here, of course, but can handle it. Government debt is low. Reserves are high. Inflation is very low compared to the U.S., meaning CNY continues to cheapen in real terms. Offshore "Chinese" USD may amount to $1tn, which could move onshore as U.S. rates decline. Remember **our chart from our last monthly** in which we showed how a rock-solid CNY insulated Asian and other EMFX from DM Japan's instability during the summer.

Exhibit 3 - CNY Insulated EM From DM Japan's Volatility

Exchange Rate Trends: CNY vs. JPY



Source: VanEck Research, Bloomberg LP. Data as of August 2024.

Exposure Types and Significant Changes

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

- We increased our local currency and hard currency sovereign exposure in Peru. Peru's inflation backdrop and outlook are extremely benign, and this leaves room for additional rate cuts without an "oversized" negative impact on the currency. In terms of our investment process, this improves the economic text score for the country.
- We also increased our hard currency sovereign exposure in Romania. We focused on the longer segment of the curve, which should benefit from lower global interest rates with policy easing already underway in the Eurozone and about to start in the U.S. We are mindful of the forthcoming parliamentary and presidential elections in Romania (both of which can temporarily increase headline noise), and the resulting high financing needs, but the country continues to benefit from sizable inflows of the EU funds, which help to alleviate some of these pressures. In terms of our investment process, this translates into the improved technical test score for the country.
- Finally, we increased our local currency exposure in Mexico. Mexico's local valuations improved a lot after the recent selloff which was caused by the market's "sudden" realization that the outgoing president's judicial reform is likely to be approved in September (even though this was clear for a few months now). The market's very large net long exposure in Mexico did not help either. We realize that the market volatility might remain high until the presidential elections in the U.S. However, the sentiment is likely to improve when President-elect Sheinbaum is inaugurated in early October, and the approval of the 2025 budget in mid-November can provide an additional powerful catalyst, because it should show significant post-election fiscal adjustment.
- We reduced our local currency exposure in South Africa. We think that the market continues to underestimate many aspects of South Africa's story - including fiscal improvements, solid external accounts, and the government of national unity's ability to implement reforms. However, local bonds rallied a lot after the elections, and we thought it would be prudent to take some profits to fund other interesting opportunities in EM.
- We also reduced our hard currency corporate exposure in China and Hong Kong. China's activity indicators continue to disappoint, but authorities are sticking to their "drip/targeted" stimulus approach. Further, there is still no progress in terms of resolving real estate issues - despite some encouraging noise regarding buying unfinished houses and converting them to rental units. These developments worsened the policy test score for China and Hong Kong.
- Finally, we reduced our hard currency corporate exposure in Brazil and Nigeria. We see no additional positive policy catalysts in Nigeria right now, which worsens the country' policy test score. Many Brazilian corporates are high beta to global recession concerns, which weakens their technical test score.

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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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