August 2021

Setup for Setback

VanEck®

Eric Fine

Portfolio Manager

VanEck Emerging Markets Bond Fund

EMBAX | **EMBUX** | **EMBYX**

Market Review

The Fund was up 0.93% based on net asset value in August, outperforming its benchmark, which was up 0.88% for the month. YTD, the Fund is up 0.04%, compared to down -1.15% for its benchmark.

We have become more defensive on EM debt, with roughly 50% of the Fund in local currency, duration of 5.1, and carry[1] of 5.5%. We have reduced exposures to higher-beta local currency markets such as Colombia, South Africa, Chile, and Brazil. We continue to favor Mexico, South Africa, Indonesia, China, and Brazil. Note that although we reduced higher-beta local currency exposure in some countries, we simply shifted into lower-beta hard-currency bonds in the same country. EM continues to have many countries with high dollar repayment capacity. Note also that when we say we favor China, we are referring to its low-risk local currency bond market which could arguably rally as the country's problems manifest, and have only one very specific corporate bond trading at prices that over-reflect risks, in our view.

EM debt - particularly some higher-beta[2] local-currency debt - appears set for a setback.

We have three key reasons for this view. First, ongoing contagion in China's offshore bond market remains an under-appreciated risk. Second, China's growth trajectory is hiccupping, at least – it led the globe out of the Covid shock, so why shouldn't it continue its leadership. Third, there is now more evidence for a "stagflation[3]" scenario in the US and global economy, with key implications (many adverse) for the markets that we focus on.

China's offshore bond market has been roiled as the Chinese authorities continue to inject "moral hazard".

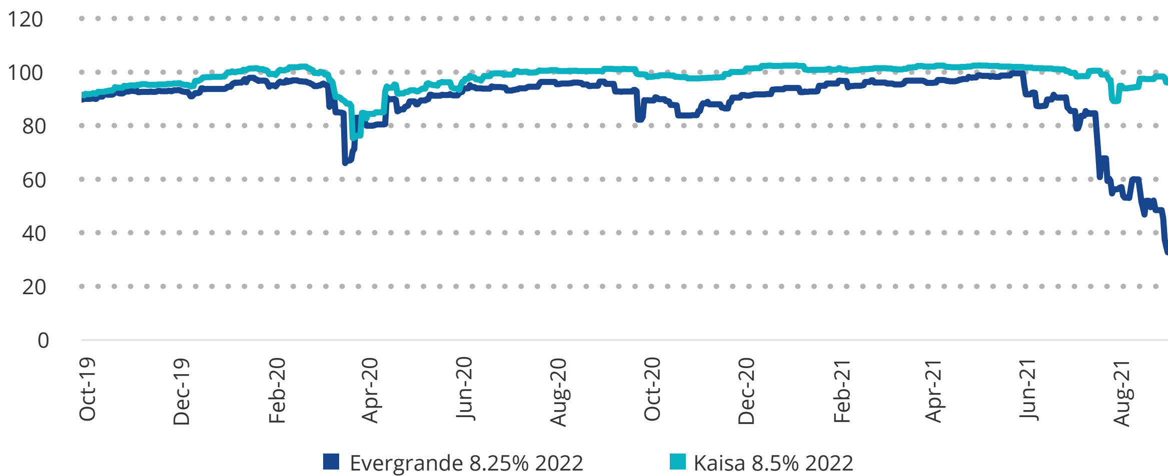
But, the roiling has so far mostly affected Evergrande (the country's biggest property developer in terms of debt issuance; 0.68% of the portfolio weight, as of 8/31/2021). We think other offshore property debt issuers are now vulnerable – the higher-risk ones more directly, the lower-risk ones indirectly simply because upside is capped, while downside is not. The worrisome dynamic is contagion on many fronts; most basic are the following. Single-B or lower names (like Kaisa in the Exhibit 1 below) are already getting sold in sympathy with Evergrande's price collapse, but only just a bit. Some higher-rated bonds are also getting sold, because they can be sold at still-high prices, and also because their upside was always low by definition (that's the nature of high-rateds, of course), and downside risk is now more apparent. Country Garden (which is among the stronger and higher-rated names) is an example – it still trades over par. Most worrying, Evergrande is reducing prices of housing units being sold, and was/is (the facts are unclear and the government may actually be preventing some asset sales at this point) trying to sell assets such as existing commercial buildings. Exhibit 1 shows Evergrande '22s against the bonds of single-B Kaisa. The point is simple – given these prices, which would you buy, the bond with all these risks priced in, or the bonds hoping that these risks will go away and which aren't paying you much while you wait. **The more this continues, the more it spreads, and the more expensive it becomes to reverse.**

[1] Carry is defined as Current Yield. 30-Day SEC Yield for Class A was 4.21% as of 08/31/2021.

[2] Beta is a measure of the volatility or systematic risk of a security or portfolio compared to the market as a whole. A security with higher beta carries more risk than a security with lower beta.

[3] Stagflation is defined as a period of inflation combined with a decline in gross domestic product.

Exhibit 1: Evergrande Sinks, Whither Others?

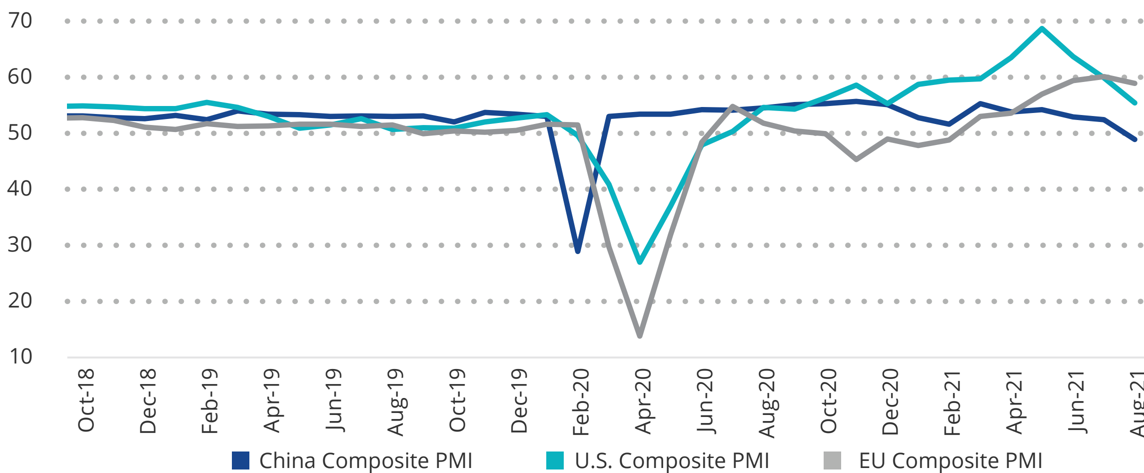


Source: VanEck. Bloomberg. Data as of August 2021.

Chinese growth appears to be hiccupping, and given its leadership role in the global recovery, this is worth worrying about.

China's August services PMI[4] dove deep into the correction zone (to 47.5 from 53.3 in July) against expectations of a mild decline to 52.0. The manufacturing PMI also undershot consensus, though it did barely manage to stay in expansion territory (50.1). The details were bad, with the new orders PMI moving into contraction for the first time since February 2020, and the new export orders PMI slipping to its weakest level (46.7) since June 2020, the large companies PMI moved perilously close to the expansion/contraction border (50.3), and the services new orders PMI collapsed to 42.2. The causes could be manifold, but include the delta outbreak/movement restrictions, supply chain issues, and high freight prices. These, though, are likely temporary. The more worrisome cause would be the regulatory overhaul which state media has called a "profound revolution". That does not sound like something that is "transitory", to use a phrase popular with the US central bank.

Exhibit 2: China Still Leading?



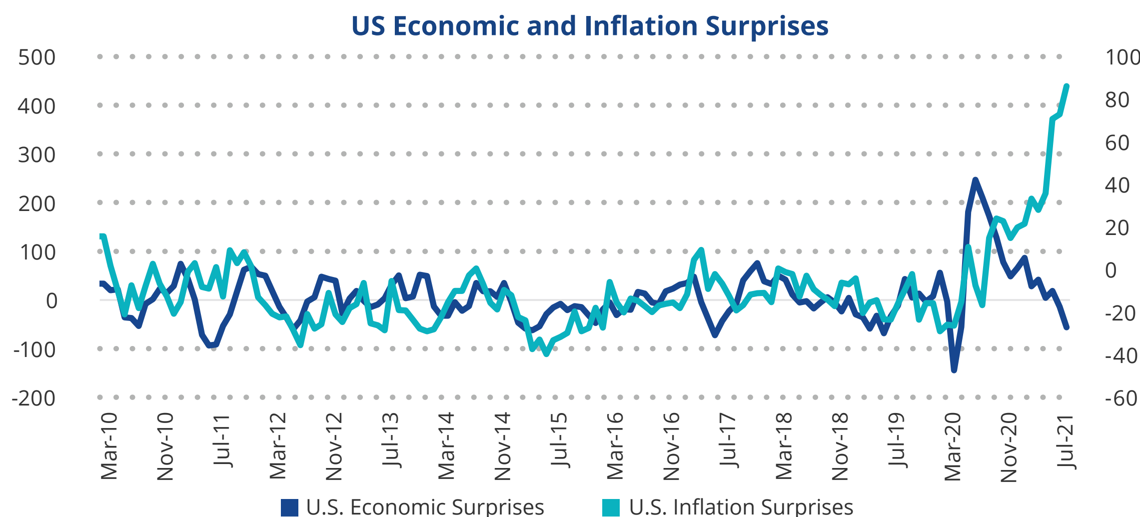
Source: VanEck. Bloomberg. Data as of August 2021.

[4] PMI Data Source: Bloomberg.

There are also global growth concerns – the "stagflation" scenario we worry about.

This scenario speaks for itself – high inflation and low growth are problematic for risky assets. This scenario also seems under-represented in the views we read, at least so far. The August non-farm-payroll number out of the US of 235,000, against a 725,000 consensus (Source: U.S. Bureau of Labor Statistics) could catalyze greater worry about this scenario. We should note that some might fear passage of the US' $3.5 trillion infrastructure bill, following statements from West Virginia Democrat Senator Manchin to the effect that a "pause" makes sense. This would challenge inflation concerns, potentially. However, we continue to think that the Democrats have no choice but to continue to push spending, and we continue to find it hard to take discussions of financing constraints (i.e. "how will this get financed?") seriously. The Fed is co-opted (knowingly or not) and even the Republican party doesn't seem to see fiscal constraints unless they are not benefiting from fiscal stimulus, in our view. Exhibit 3 is one of our favorite charts, was inspired by Matthew Sigel, VanEck's Head of Digital Assets Research; it speaks for itself.

Exhibit 3: Inflation Surprises Up, Growth Surprises Down



Source: Matthew Sigel, VanEck's Head of Digital Assets Research. Data as of August, 2021.

These three risks raise the odds of a fourth – China may be heading for an external adjustment, i.e., a weaker currency.

Very simply, if capital account flows are challenged by Chinese policy, and global "stagflation" challenges current account flows, China will need dollars. The only option in this scenario would be to reduce the value of the currency (perhaps with increased capital controls, though Chinese policy is already implicitly re-imposing them). This will take several quarters to play out, if it does, but bears watching. Related, Chinese real estate prices strike us as central to China's future. Real estate sales account for around 10% of GDP and the stock of real estate accounts for around 45% of household wealth (Source: Bloomberg). China's "common prosperity" policies would seem to point toward lower real estate prices, moreover, though some argue that this will be met by low-income housing construction. Anyway, our point is that if China was experiencing problems in other sectors, we wouldn't be as concerned.

There remain plenty of attractive - albeit more uncorrelated or defensive - EM bonds.

Zambia is moving towards an IMF agreement, Ecuador's policy (and IMF agreement) continue to bear fruit, Peru's new government is becoming market-friendly, El Salvador's bonds are cheap enough to reflect near-term risks, etc. Also, one of our longstanding points is that many EM countries have plenty of dollar assets relative to dollar liabilities, so the dollar bonds of several countries that might have other problems, remain very defensive in our opinion (the song would be titled: Ninety-Nine Problems But Dollars Ain't One). Brazil, Chile, Colombia, South Africa, and others are among these.

EXPOSURE TYPES AND SIGNIFICANT CHANGES

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

- We increased our local currency exposure in Thailand and Mexico. One of the main reasons in Thailand is that the COVID outbreak might be easing (fewer cases) and the pace of vaccinations is accelerating, both of which are growth-positive. The country's current account should benefit from weaker imports, while the international reserves' dynamics suggest that the central bank is not particularly happy about the currency's depreciation. In terms of our investment process, this improved Thailand's policy and economic test scores. As regards Mexico, our decision is the continuation of the last month's story. Mexico stands to piggyback on the U.S. recovery and the infrastructure stimulus. The growth outlook is a bit brighter now (recovering PMIs), while the central bank might have no other option but to remain hawkish, as core inflation is sticky above the target range. In addition, local bond valuations are still attractive. This improves the country's economic, policy and technical test scores.
- We also increased our local currency exposure in Zambia and the Philippines. The main catalyst in Zambia was the outcome of the presidential elections. The unexpected first-round victory of the opposition candidate should be positive for governability and the country's overall economic prospects. In terms of our investment process, this improved the economic and policy test scores for the country. As regards the Philippines, we decided to cover an underweight position due to the currency's cheapness relative to short-term fundamentals. The latter improved the technical test score for the country.
- Finally, we increased our hard currency sovereign exposure in El Salvador, Saudi Arabia, and United Arab Emirates, and hard currency corporate exposure in South Korea. The main drivers in El Salvador were cheap valuations (bonds sold off too much - we bought the lowest USD price bond), the sharper recovery, more supportive external demand, and surging overseas remittances. In terms of our investment process, this improved the country's technical and economic test scores. We are mindful, however, that the government might use the 200th independence anniversary to announce some reforms, and we'll continue to monitor this potential risk in September. As regards the United Arab Emirates, higher oil prices improved the near-term economic outlook. Saudi Arabia's story is very similar - macroeconomic fundamentals are very strong, the budget deficit is declining (reducing the need for bond issuance), and the international reserves appear to be on the mend. In terms of our investment process, this strengthened the country's economic and technical test scores. Finally, South Korean corporate issue was a green bond with attractive valuations - a welcome combination of supportive technical factors and ESG credentials.
- We reduced our local currency exposure in Colombia, South Africa, and Chile. Colombia's bonds no longer looked as cheap as before, which worsened the technical test score for the country. In addition, Colombia does not screen well on two metrics: (1) non-resident holdings of local bonds (much higher than during the 2013 taper tantrum), and (2) twin deficits (expected to be the worst among major EMs in 2021 and 2022). These weakened the economic test score for the country as well. On-going concerns about the fiscal deficit/bond supply was the main reason in South Africa, as this weighs both the economic and technical test scores for the country - we used a rally to reduce local exposure. In Chile, a risk of a more populist policy bias after the presidential elections worsens the policy test score the country (and sours investors' sentiment).
- We also reduced hard currency corporate exposure in Iraq, Pakistan, and the Dominican Republic. The key risk in Iraq was the proximity of the elections, which can create additional headline noise and volatility, especially after the recent events in Afghanistan. In terms of our investment process, this worsened the policy test score for the country. A risk of Afghanistan's "contagion" was the main reason in Pakistan as well - this worsened the country's technical test score. As regards, the Dominican Republic, we had some duration concerns due to sovereign bonds' very low spread-to-yield ratio. This worsened the technical test score for the country.
- Finally, we also reduced hard currency quasi-sovereign exposure in Qatar, and hard currency corporate exposure in India and Jamaica. The reduction in Qatar reflected a very low spread-to-yield ratio, which weakened the country's technical test score. One of our corporate bond holdings in India suffered from the same condition (low spread-to-yield ratio), so we chose to close the position. A corporate bond in Jamaica had a negative yield due to call, so its risk-return profile no longer looked attractive.

Average Annual Total Returns (%)

As of August 31, 2021	1 Month†	3 Month†	YTD	1 Year	5 Year	Life
Class A: NAV (Inception 7/9/12)	0.93	-0.81	0.04	6.17	5.35	2.87
Class A: Maximum 5.75% Load	-4.88	-6.52	-5.71	0.07	4.11	2.21
Class I: NAV (Inception 7/9/12)	0.94	-0.72	0.25	6.60	5.65	3.17
50 GBI-EM GD / 50% EMBI GD	0.88	0.63	-1.15	4.41	3.85	3.01

As of June 30, 2021	1 Month†	3 Month†	YTD	1 Year	5 Year	Life
Class A: NAV (Inception 7/9/12)	-0.72	3.91	0.14	14.25	5.44	2.94
Class A: Maximum 5.75% Load	-6.43	-2.06	-5.62	7.68	4.19	2.26
Class I: NAV (Inception 7/9/12)	-0.69	3.94	0.29	14.41	5.73	3.23
50 GBI-EM GD / 50% EMBI GD	-0.24	3.81	-2.01	7.09	4.11	2.97

† Monthly returns are not annualized.

Expenses: Class A: Gross 2.30%; Net 1.25%. Expenses are capped contractually until 05/01/22 at 1.25% for Class A. Caps exclude acquired fund fees and expenses, interest expense, trading expenses, dividends and interest payments on securities sold short, taxes and extraordinary expenses. Please note that, generally, unconstrained bond funds may have higher fees than core bond funds due to the specialized nature of their strategies.

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 temporary contractual 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 investors' 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 Net Asset Value (NAV). An index's performance is not illustrative of the Fund's performance. Certain indices may take into account withholding taxes. Index returns assume that dividends of the index constituents in the index have been reinvested. Investing involves risk, including loss of principal; please see disclaimers on next page. Please call 800.826.2333 or visit vaneck.com for performance current to the most recent month ended.

Source: VanEck, Bloomberg.

Prior to May 1, 2020, the Fund was known as the VanEck Unconstrained Emerging Markets Bond Fund.

International Monetary Fund (IMF) is an international U.S.-based organization of 189 countries focused on international trade, financial stability, and economic growth.

The World Government Bond Index (WGBI) measures the performance of fixed-rate, local currency, investment-grade sovereign bonds. The WGBI is a widely used benchmark that currently comprises sovereign debt from over 20 countries, denominated in a variety of currencies, and has more than 30 years of history available The WGBI is a broad benchmark providing exposure to the global sovereign fixed income market. The Blended 50/50 Emerging Markets Debt Index is an appropriate benchmark because it represents the various components of the emerging markets fixed income universe.

Duration measures a bond's sensitivity to interest rate changes that reflects the change in a bond's price given a change in yield. This duration mea- sure is appropriate for bonds with embedded options. Quantitative Easing by a central bank increases the money supply engaging in open market operations in an effort to increased lending and liquidity. Monetary Easing is an economic tool employed by a central bank to reduce interest rates and increase money supply in an effort to stimulate economic activity. Correlation is a statistical measure of how two variables move in relation to one other. Liquidity Illusion refers to the effect that an independent variable might have in the liquidity of a security as such variable fluctuates overtime. A Holdouts Issue in the fixed income asset class occurs when a bond issuing country or entity is in default or at the brink of default, and launches an exchange offer in an attempt to restructure its debt held by existing bond holding investors. Carry is the benefit or cost for owning an asset.

All indices are unmanaged 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. Certain indices may take into account withholding taxes. An index's performance is not illustrative of the Fund's performance. Indices are not securities in which investments can be made. 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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Investors should consider the Fund's investment objective, risks, charges, and expenses of the investment company carefully before investing. Bond and bond funds will decrease in value as interest rates rise. The prospectus and summary prospectus contain this and other information. Please read them carefully before investing. Please call 800.826.2333 or visit vaneck.com for performance information current to the most recent month end and for a free prospectus and summary prospectus.

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