

Bad Bonds Plus Uncertain China = EM Bond



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Risks to bonds, including higher U.S. interest rates, are multiplying – but given emerging markets uncorrelated economies and asset prices, we are still finding attractive opportunities.

In August, the [VanEck Emerging Markets Bond Fund](#) returned -2.70% compared to -2.08% for its benchmark (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 as of August 31, 2023, the Fund is up 4.74%, compared to 6.17% for its benchmark. Malaysia and Thailand, where we had significant underweights in local currency, were the big winners for the month. We are looking to cover our significant underweight there in September. China, where we have been accumulating corporate bonds at very low prices, was the biggest detractor for the month. We are looking to keep accumulating in China, which remains our biggest winner year-to-date. We end August with carry of 6.63%, a yield-to-worst of 9.95%, duration of 4.5, and roughly 45% of the Fund in local currency. We have no Mexico local currency, which strikes us as very vulnerable, and are looking to reduce our already low exposure to Eastern European local markets. Our biggest exposures are Brazil (local), Mexico (hard), South Africa (local), Indonesia (local), and Colombia (local).

Average Annual Total Returns (%) as of August 31, 2023

	1 Month [†]	3 Month [†]	YTD	1 Year	3 Year	5 Year	10 Year
At Net Asset Value	-2.70	1.52	4.74	8.26	-0.71	2.85	1.75
At Maximum 5.75% Sales Charge	-8.29	-4.32	-1.28	2.03	-2.65	1.64	1.15
50% GBI-EM/50% EMBI	-2.08	2.96	6.17	8.52	-3.25	0.88	1.51
GBI-EM Index	-2.69	3.38	7.92	11.34	-2.25	1.20	-0.07
EMBI Index	-1.50	2.62	4.48	5.77	-4.32	0.47	3.01

Average Annual Total Returns (%) as of June 31, 2023

	1 Month [†]	3 Month [†]	YTD	1 Year	3 Year	5 Year	10 Year
At Net Asset Value	2.66	2.27	5.93	14.28	2.09	3.12	1.74
At Maximum 5.75% Sales Charge	-3.24	-3.61	-0.16	7.71	0.10	1.90	1.14
50% GBI-EM/50% EMBI	2.75	2.36	5.95	9.43	-2.22	0.48	1.18
GBI-EM Index	3.26	2.51	7.79	11.38	-1.42	0.29	-0.56
EMBI Index	2.23	2.19	4.09	7.39	-3.10	0.55	2.82

[†] Returns less than one year are not annualized.

Expenses: Class A: Gross 2.55%, Net 1.27%; Class I: Gross 2.51%, Net 0.97%; Class Y: Gross 2.91%, Net 1.02%. 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.

Much of this piece is a re-run from last month, as its key point about the challenge of higher rates globally now seems more confirmed by market action.

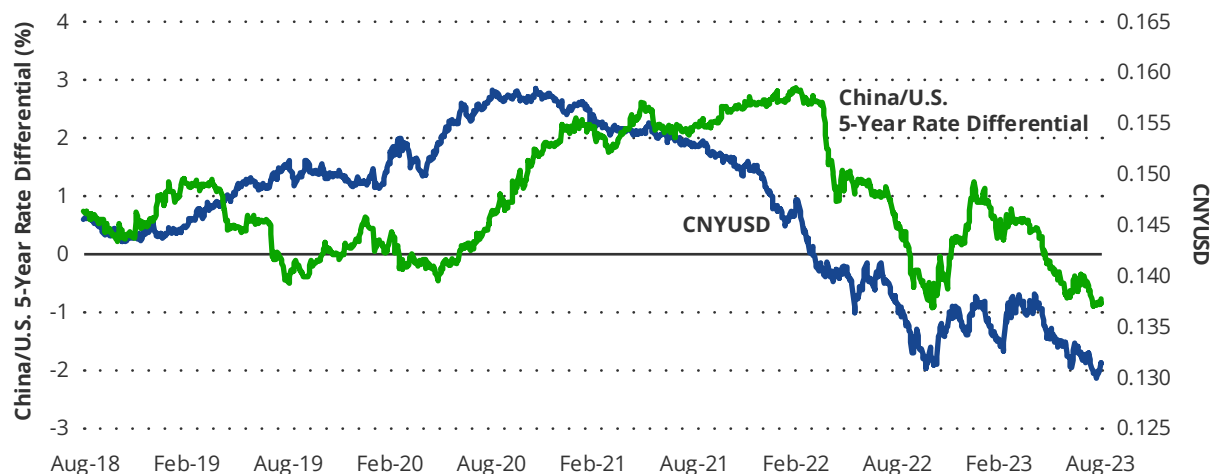
After a relief rally off the 4.40%ish high to just above 4.10%ish, the 10-year U.S. Treasury has sold off. "Higher for longer" and the need for all risk markets to discount that scenario are now more clearly beginning to dominate. Most went into this summer and the presumed end of the Fed hiking cycle long duration, to our eye, whether in bonds directly or risk more generally (i.e., infinite-duration equities). And, the market also seems to understand the impact of the Bank of Japan's ability to choose how to manage liquidity – by reducing either Japanese government bonds (JGBs) or U.S. Treasuries, the latter obviously having an impact on U.S. and global duration. The same goes for the People's Bank of China's interventions, though those are focused on managing the currency. Either way, they are sellers of U.S. duration.

Risks to bonds are multiplying. A Fed declaring victory on inflation too soon, a U.S. Treasury accelerating borrowing in 2023, a Bank of Japan allowing yields to rise in a market known to fund offshore carry trades, "fiscal dominance" in the U.S., UK, and other developed markets (DMs), and geopolitical facts (to which we continue to see great market denial) – all conspire toward higher yields. We'll start with the Fed. At its latest FOMC meeting, it paused rate hikes just after Fed Funds poked its head above its favored inflation measure (core PCE), when normally pauses happen several hundred basis points above core PCE. And this pause, even though since the previous meeting commodity and oil prices in particular had risen. In fact, the bulk of the inflation decline the Fed is declaring victory on might not only not yet be over, but was dominated by goods prices, not wages or services. Watch labor prices, particularly with labor unions activated and supported largely by both the left and right.

We won't say much about Treasury borrowing because we were early adopters of the "fiscal dominance" framework applied to DMs. We will re-emphasize that policymakers and market participants will be unable to accommodate this thinking because it doesn't fit their frameworks and humans in groups just don't change those until they explode, in our opinion. Because U.S. Treasuries are assumed, a priori, to be "risk-free", any curve steepness must be attributed to "term premium" (i.e., basically related to inflation), and not related to credit risk. Many will be looking at a radar screen that is no longer the guide it was, also a favorite of human groupings going back millennia. Good luck. And we know the sellers! The Bank of Japan is in a great position because it can sterilize, or not, its bond market interventions – it can sell JGBs, but if that pressures the yen or yields too much, they can just sell U.S. treasuries. China can, too, by the way. Good luck, again.

Good policy in emerging markets generally is an independent driver. As always, EM has plenty of uncorrelated economies and asset prices. High real interest rates in commodity-exporting countries like Colombia and Brazil, and low inflation in countries like most of EM Asia, remind how EM has generally been weathering these ongoing DM-led adverse scenarios. There are a lot of strong EM setups in the current environment. A Brazil beginning an overdue easing cycle while its balance-of-payments accounts continue to be a juggernaut is an obvious one. The country has lower inflation than the UK and Australia, and near-10%-positive real interest rates. Unfortunately, a lot of the other EM "majors" don't pass our tests, but we have found right-sized positions in Peru and Indonesia for other "majors" and in Uruguay, Dominican Republic, Zambia, and Sri Lanka for "minors". Colombia could be a "major" that wins, too, and we increased exposure there in August. It's basically the only pure oil-beta among the "majors". Whatever you think about the Fed, they aren't thinking about it in Sri Lanka and shouldn't. Talk about uncorrelated. If you want to get a sense of how un-anchored the core EM currencies and Chinese renminbi, could become, look at the chart below. With the U.S. in "higher for longer" and China in "stimulus mode", there are serious risks to China's currency.

China's Interest Rate Differential with U.S. Means Pressure on CNH and Related EM Currencies



Source: VanEck, August 2023. Past performance is no guarantee of future results.

Quid nos facere? Everyone got long carry and went on their summer holidays... and now rates are at risk of breaking big levels (4.4% on the 10-year Treasury is our level) to the upside. To us, this means big risks to bonds, especially duration, and extreme curation on EM local currency markets that are correlated with U.S. rates. Mexico local currency looks very vulnerable to us. Cash should be well above average, until the tilt is priced or rejected. “Sheep gotta do what sheep do and cannot do otherwise”, and that is follow the other sheep while the hyenas make their plans. But even the hyenas have to fear the lion. And the lion is walking about. That lion is rising rates.

Exposure Types and Significant Changes

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

- We increased our local currency exposure in the Czech Republic and Brazil, and hard currency corporate exposure in Brazil. The Czech National Bank is probably the only central bank in the region that is unlikely to engage in premature policy easing – a factor that improves the country’s policy test score within our investment process. Brazil’s real interest rate cushion is still among the highest in EM, and the central bank clearly signaled that it will not be accelerating the pace of rate cuts, keeping an eye on both the inflation target (as the base effect became a headwind) and the government’s fiscal performance. This also supports the policy test score for the country. The corporate bond in Brazil is one of the lower-cost producers globally of steel and iron ore, which might benefit from China’s stimulus with its emphasis on supply-side measures.
- We also increased our local currency exposure in Malaysia, South Korea, and Indonesia. Disinflation is still on track in all three countries, central banks are not in a hurry to cut, and we also think that currencies can benefit if China’s renewed policy stimulus improves the growth outlook, giving a boost to the countries’ technical test scores.
- Finally, we increased our hard currency corporate exposure in South Africa, Burkina Faso, and India, as well as hard currency sovereign exposure in Ecuador. Ecuador’s assets sold-off too much after the assassination of a leading presidential candidate, while fundamentals/structural factors did not look nearly as bad as the price correction implied. In terms of our investment process, this improved the technical test score for the country. The gold-mining company in Burkina Faso is one of the strongest operators in the world, which is also actively diversifying its country exposure. In India, we bought a new issue, which is consistent with our investments in India’s renewables.
- We reduced our local currency exposure in Chile, and hard currency corporate exposure in Thailand. While some EM assets can benefit from a moderate growth rebound in China, high-beta currencies in countries where central banks are aggressively frontloading rate cuts (Chile) might not be that lucky. Thailand was expected to be among the major beneficiaries of China’s post-pandemic reopening, but these benefits take a longer time to materialize, and this worsened the technical test score for the country.
- We also reduced our hard currency sovereign exposure in Nigeria and Egypt, as well as hard currency sovereign and local exposure in Uzbekistan. We see no additional near-term catalysts in Uzbekistan, while the impact of the relatively uneventful elections is waning off. In regards to Nigeria and Egypt, our main concerns are reforms rollback, the uncertain policy direction, and inability to stick to ambitious structural programs. This explains why the initial market euphoria that accompanied catchy headlines was short-lived, as authorities failed to deliver on execution. In terms of our investment process, this worsened the policy test score for both countries.
- Finally, we reduced our hard currency sovereign exposure in Hungary, Romania, Serbia, and Morocco. The Euro zone’s growth outlook remains gloomy – a major headwind for small open Central European economies, which also affects the technical test score for these countries. As regards Morocco, our main concern is that valuations are getting stretched, limiting upside if global sentiment continues to deteriorate.

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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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