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EM Debt: Safe Ship in Stormy Seas

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VanEck Emerging Markets Bond Fund

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

Overview

In March, the VanEck Emerging Markets Bond Fund (the Fund) returned 1.50%, compared to 2.54% 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), generating underperformance of 104 basis points (bps). This underperformance was because local currency was the big champion in March, consistent with our outlook. The Fund has a maximum allowed allocation of 60% of AUM to local currency, in line with its benchmark. Year-to-date (YTD), the Fund returned 3.58%, compared to 3.51% for its benchmark, resulting in outperformance of 7 bps. As of end-March, local currency exposure was 55.20%, duration was 5.41 and carry was 6.06%.

DMs are once again threatening global markets, with the US (and Switzerland) facing a banking crisis. However, while it might appear "resolved" (due to yet more de-facto guarantees on central bank money liabilities), once again, emerging markets (EM) aren't the problem and were the solution. A tumultuous few months have strengthened our conviction that money will flow out of DM bonds and toward EM bonds due to "fiscal dominance" in DM. We continue to ask why non-US-aligned central banks would not seek to reduce their ratio of US treasuries as assets, and replace them with gold and EM local-currency bonds. Do they have a choice, given the politicization of the use of US dollars? Reserve status is a function of underlying geopolitical configurations, more on that "most important thing" later. EM local currency was a big winner in March. There's really no better argument for our thesis than that outcome. The GBI-EM local currency index was up over 4% in March, in the midst of a still-resolving US (and Swiss) banking crisis.

Exhibit 1 – EM Local Currency Went Straight to Winning in Crisis-Driven March

Source: Bloomberg. Data as of MTD ending 3/31/2023. Past performance is no guarantee of future results.

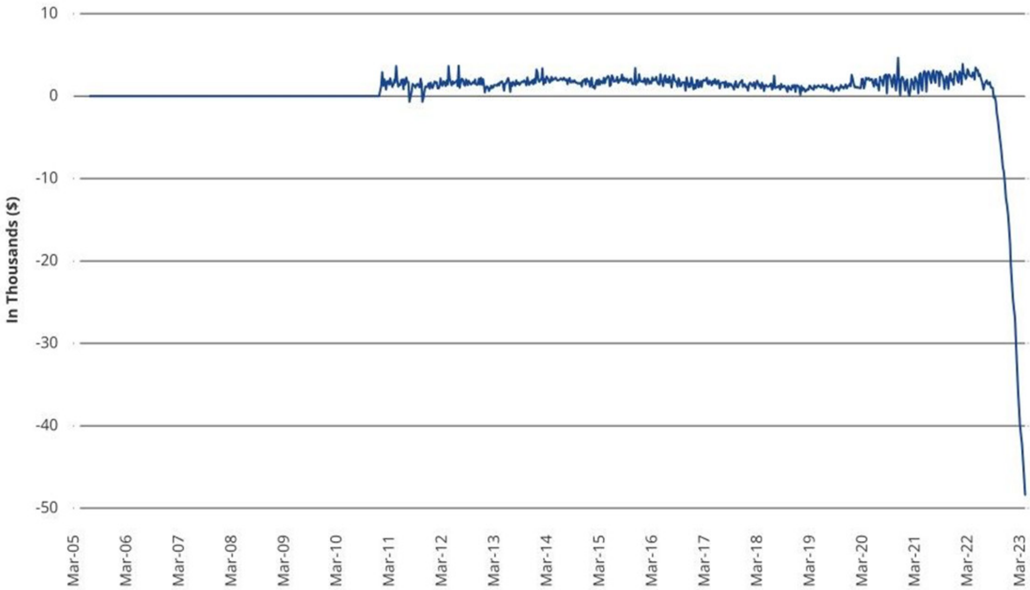
As seen on TV! The biggest risk! The advent of a new geopolitical configuration involving an integrating alliance of nations that are:

- Major developed markets (DM) countries are highly indebted, which when combined with recession-aversion means constrains monetary policy ("fiscal dominance")
- DMs are thus constrained in their ability to hike rates, which would cause recessions and/or ultimately "bankrupt" their governments
- This being unacceptable, thus their currencies will bear the burden
- Currency declines in DM may initially appear painless due to ex-post low FX-passthrough-to-inflation and the structural demand form US dollar in risk-off due to most debt being in US dollar terms
- Major DM debtors respond to financial crisis or even simple recession risk with liquidity (in DM currencies)
- Heavily-indebted DMs are sanctioning their creditors
- Economically orthodox EMs are going their own way
- EMs have well-capitalized banking systems (common-equity to assets in EMs is two standard deviations superior to DM's…think about that…and loan-to-deposit ratios also favor EMs, other than outliers such as South Africa and Chile)
- EMs often have strong and improving structural reform from Indonesia to Angola (subsidy reform, tax and regulatory simplification, e-government, etc.), world-class bureaucrats and elites that fluent in multiple languages, and trained in western educational traditions
- EMs are DM's best students. As our economist, Natalia Gurushina likes to say: "they are the graduates!"

Too many business models rely on the old geopolitical configuration, which is too bad. Get over it and be positioned, we think. The market is not priced to reality, it is priced to the bureaucratic inertia and natural human denial that characterize western financial centers, to our eye. This is the biggest mispricing we see in markets. China, Russia, Saudi Arabia, United Arab Emirates, Iran, India, Brazil, South Africa, and more, are increasingly using each other's currencies in trade. Notice, by the way, the confluence of energy-suppliers, to which the Federal Reserve has no tools. Just wait until finance, that is, borrowing in each other's currencies, gets started! This creates secular money demand, which can be met by secular money supply. The result of this non-inflationary expansion of EM balance sheets is massive growth and fiscal space for the EM! This is precisely what the US leveraged the past several decades – a secular increase in money supply, which was non-inflationary because the money was demanded by orthodox monetary policy (i.e., Volcker providing reserve-currency status to the Saudis), then orthodox fiscal and structural policy (President Reagan's and President Clinton's welfare and structural reforms, but also the fraught increase in financial de-regulation, and the all-stick-no-carrot attitude to the world). And then more, on steroids, under Presidents Bush and President Obama. This process will take a decade, for sure. But it's the major secular trend. And, *it's literally on TV - get over it and position.*

As a result of this history, there is nothing left for US policy other than endless morphine. As in liquidity provision. The US policy response is limited to pure liquidity provision, which means more un-demanded dollar supply. Everyone can measure money supply, no one can measure money demand other than by observation. Money will flow offshore from the US as a result, in our opinion. Asset quality at the Fed (will it include commercial real estate in some form?) will be the victim on the asset side, and simple money will be the victim on the liability side. Which means endless dollars. This would cause a major, secular dollar deterioration from a money supply perspective. And policy rates can't rise (due to societal rejection of recession as an option, and "fiscal dominance" in the DM, both of which we've discussed in previous blogs). Many investors ask about our opinions (to be clear, not portfolio-drivers) on US rates. Here it is: It seems like pure duration is very vulnerable. As a simple thought experiment – if the Fed hikes today, they cut even more the next day/week/month, and the yield curve steepens. And if they cut, the curve steepens. And, if you tell us the 2-year US Treasury rallies to the 1% handle, we actually see it. *It fits our investment process's lower duration. But it's not the reason for it.*

Exhibit 2 – Fed Operating Loss



Source: Bloomberg LP. Data as of April 12, 2023. Past performance is no guarantee of future results.

Without profound structural reform or a reversal of long-in-train geopolitical developments that are only now being acknowledged, DMs are on their heels for a decade. We see no prospect of any serious structural or fiscal reform in the DMs (perhaps excluding Japan, but monetary and fiscal have more to go, and we've discussed our views on Japan's yield curve control elsewhere...maybe Japan is good for Japan, but bad for the west?). Anyway, our theses seem somewhat well-paved at this point.

Exposure Types and Significant Changes

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

- We increased our hard currency sovereign exposure in Ukraine and Turkey. The Ukrainian government consistently shows willingness to honor its debt obligations. We recognize that continuing military actions pose risks and create uncertainty, but Ukraine's relatively light schedule for the next several months bodes well for the technical test score for the country. Turkey's idiosyncratic policy mix is one of the main reasons why we stay away from local debt, but the country's sovereign debt is now attractively valued, while the unorthodox FX framework somewhat reduced pressure on the international reserves. In terms of our investment process, this improved the technical test score for the country.

- We also increased our hard currency sovereign exposure in Qatar and Saudi Arabia. Both countries are among the key beneficiaries from higher oil prices due to Russia's invasion of Ukraine - especially as it relates to growth, fiscal positions, and external balances. Saudi Arabia also demonstrates consistent structural efforts to strengthen governance and diversify the economy from oil. In terms of our investment process, this improved the economic, policy, and technical test scores for the country.

- We increased our hard currency sovereign exposure in Pakistan, Honduras, and Democratic Republic of the Congo. Pakistan's politics remain volatile, but the country's bonds are attractively valued (the highest initial allocation bucket #1), and it is on track to get an extension of the IMF program until mid-2023. In the meantime, the central bank is trying to maintain a tight monetary policy stance, which should help to alleviate external pressures. In terms of our investment process, this improved the policy test score for the country. In regards to Honduras, the peaceful transition of power and the government's supportive stance towards the private sector (as well as the favorable impression during the IMF meetings) strengthened the policy test score for the country. Democratic Republic of the Congo is making good progress towards an IMF deal, and its bonds were very attractively valued, improving the country's policy and technical test scores.

- We reduced our hard currency sovereign exposure in Hungary and local currency exposure in Poland. In Hungary, the ruling party's re-election with a larger-than-expected margin, and signals that it can get embroiled in the Russia/Ukraine war in addition to political/legal complications with the EU - which can potentially cost it disbursements from the EU's recovery funds - worsened the country's policy/politics test score. Poland is very exposed to the fallout from the Russia/Ukraine war. The recent cutoff of Russian gas supplies shows that upside inflation risks can prove more persistent. The government's expansionary fiscal stance can create additional technical issues for local debt. In terms of our investment process, this negatively affected the technical and policy test scores for the country.

- We also reduced our local currency exposure in Brazil, hard currency corporate exposure in Moldova, and hard currency sovereign exposure in Angola. The Brazilian réal's super-stretched net long positioning means that it can easily get caught in the global sell-off on the back of China growth concerns. Against the backdrop of the deteriorating technical test score, we decided to take partial profits on this position, which worked extremely well early in the year. In Moldova, we sold a corporate bond after the company lost access to the sea after Russia attacked Ukraine.
- Finally, we reduced local currency exposure in Malaysia and Thailand. Malaysia can easily be affected by the Chinese renminbi's depreciation, as the ringgit has one of the highest correlations with renminbi on multiple time horizons. This worsened the technical test score for the country. In Thailand, we swapped from local to quasi-sovereign exposure due to "twin" concerns about the Chinese renminbi's depreciation and the impact of China's zero-COVID policy on tourism. Both factors worsened the country's technical and economic test scores.

Average Annual Total Returns (%)

As of March 31, 2023	1 Month†	3 Month†	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 7/9/12)	1.50	3.58	3.58	-0.38	8.30	0.85	0.33
Class A: Maximum 5.75% Load	-4.34	-2.38	-2.38	-6.11	6.19	-0.34	-0.26
Class I: NAV (Inception 7/9/12)	1.52	3.42	3.42	-0.04	8.60	1.14	0.63
50 GBI-EM GD / 50% EMBI GD	2.54	3.51	3.51	-3.81	0.48	-1.43	0.29

As of December 31, 2022	1 Month†	3 Month†	YTD	1 Year	3 Year	5 Year	10 Year
Class A: NAV (Inception 7/9/12)	2.82	10.32	-7.73	-7.73	-0.64	0.67	0.27
Class A: Maximum 5.75% Load	-3.09	3.98	-13.04	-13.04	-2.58	-0.52	-0.33
Class I: NAV (Inception 7/9/12)	2.93	10.43	-7.21	-7.21	-0.30	1.00	0.59
50 GBI-EM GD / 50% EMBI GD	1.24	8.30	-14.73	-14.73	-5.64	-1.85	-0.17

† Returns less than one year are not annualized.

Expenses: Class A: Gross 2.33%, Net 1.28%; Class I: Gross 1.74%, Net 0.96%. Van Eck Associates Corporation (the "Adviser") has agreed to waive fees and/or pay Fund expenses to the extent necessary to prevent the operating expenses of the Fund (excluding acquired fund fees and expenses, interest expense, trading expenses, dividends and interest payments on securities sold short, taxes and extraordinary expenses) from exceeding 1.25% for Class A and 0.95% for Class I of the Fund's average daily net assets per year until May 1, 2023. During such time, the expense limitation is expected to continue until the Board of Trustees acts to discontinue all or a portion of such expense limitation. Please note that, generally, unconstrained bond funds may have higher fees than core bond funds due to the specialized nature of their strategies.

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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.

Definitions

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 measure is appropriate for bonds with embedded options.

Carry is the benefit or cost for owning an asset.

A **handle** is the whole number part of a price quote, that is, the portion of the quote to the left of the decimal point.

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