Emerging Markets Debt: Hold Steady, Until Bonds Stabilize

By Eric Fine, Portfolio Manager

VanEck Emerging Markets Bond Fund

USD R1 Inc: IE00BYXQSJ74 USD M Inc*: IE00BYXQSH50
USD I1 Inc: IE00BYXQSF37 EUR Hedged I1 Inc: IE00BYXQSD13
USD I2 Inc: IE00BYXQSG44 EUR Hedged I2 Inc: IE00BYX22V58
* Investment through authorized financial institutions only.

Fund Review

The VanEck Emerging Markets Bond UCITS (Class USD I1) returned -2.25% in September compared to a return of -2.98% for the 50/50 J.P.Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM) local currency and the J.P.Morgan Emerging Markets Bond Index (EMBI) hard-currency index.

Average Annual Total Returns (%) as of 30 September 2023

	1 Mo	3 Mo	1 Yr	3 Yr†	Life†
USD R1 Inc (Inception 12/06/14)	-2.29	-3.49	13.34	-0.8	-0.52
USD I1 Inc (Inception 20/08/13)	-2.25	-3.36	13.91	-0.15	1.61
USD I2 Inc (Inception 20/08/13)	-2.24	-3.34	14.02	-0.05	1.73
EUR Hedged I1 Inc (Inception 06/10/15)	-2.39	-3.89	10.77	-2.09	0.81
EUR Hedged I2 Inc (Inception 22/08/17)	-2.38	-3.86	11.04	-1.95	-0.91
50% GBI-EM/50% EMBI - USD[1]	-2.98	-2.73	11.61	-3.58	1.05

† Periods greater than one year are annualized.

[1] Life performance for the 50% GBI-EM/50% EMBI - USD benchmark is presented in U.S. Dollars (USD) as of Class I1 inception date of 20/8/2013

This outperformance is despite a last-day-in-September rally in high-beta risk, which we have been avoiding. We are largely staying out of the way of the sell off until global bonds stabilize. We are very slowly buying selected longer duration corporates. We are also looking at emerging markets (EM) local markets that we like for fundamental reasons, but whose beta makes them very vulnerable currently. Long-duration investment grade is also on our radar. But nothing is flashing buy yet. We ended September with carry of 6.2%, yield to worst (YTW) of 10.54%, duration of 3.9, and roughly 35% of the fund in local currency. Cash is an unusually high 10% as the fund braced for September (and early October). Our biggest exposures are Brazil (local), Mexico (hard), South Africa (local), Indonesia (local), and Colombia (local).

The 30-year US Treasury crossed above 5% (in early October); US and global rates are driving EM debt as well as global markets weaker. Our biggest view has been to avoid duration, and that remains our view for now as this continues to play out in markets. September was a tough month for all bonds, with UST 10-year US Treasury down 3.5%, the Global Agg down 3.0%, and EM Blend down 3.0%.[1] Within EM, local markets' appearance of acceptable performance in September is very misleading as the last day of the month saw a massive technical rally in all markets (which faded the very next market open in October), so keep that in mind. (September was looking to be an even better month of outperformance for the fund, if it were not for the last day of trading.)

What's next/catalysts? After the early October Non-Farm Payroll (NFP) report, the next catalyst is probably another hike from the Fed. This is not priced in and is the next new hill to climb. More follow-on weakness seems likely in October. Outflows from bonds, generally, is a clear risk. Market strategists are entering a bit of panicmode, hoping for a stock market crash. To which we respond: "the turn in rates is not the turn in risk". Prior to the latest bond panic, investors were by-and-large betting that the Fed was done hiking. We've said many times that "the turn in rates is not the turn in risk", but who listens to us? Anyway, investors embraced this view that the Fed was done (with which we are very sympathetic), and turned it into bullish duration, bullish EMFX, and bullish risk positions. "Higher for longer" and data (GDP, PMIs are strong, labor seems tight, October NFP was a blow-out, etc.) was a punch in the nose to that view. Our adverse view towards duration has been pronounced and remains, but it is slowly getting priced in by markets, so we have to start thinking about adjusting our underweight in duration. (Getting ready would be a better description – finding bonds,

[1] Source: ICE Data Indices and J.P. Morgan as of 9/30/2023. UST 10y is measured by the ICE BofA Current 10 Year US Treasury Index; Global Agg is measured by the ICE BofA Global Broad Market Plus Index; EM Blend is measured by 50% J.P. Morgan EMBI Global Diversified/50% J.P. Morgan GBI-EM Global Diversified.

levels, and catalysts that are meaningful to our process, which is what we're doing).

Again, one of our big themes has been *"the turn in rates is not the turn in risk"*. Too many, in our view, have rigid reaction functions that say something along the lines of "buy investment grade, or buy high yield, or buy stocks, even, when the Fed is done". The problem is that the Fed being done could involve recession risks, which would be adverse for still-tight investment grade bonds and always-illiquid high yield corporates. It is not obvious that one is supposed to jump in now. And, perhaps more importantly, **the Fed is not done.** With the first NFP print in early October we see a still-hot US economy and a Fed that probably isn't done hiking, yet alone pausing and cutting. All of this is consistent with our stance of staying out of the way, letting the market find its levels, and keeping an eye on valuations.

Exhibit 1 – Catalysts? *The Turn in Rates is Not the Turn in Risk!*

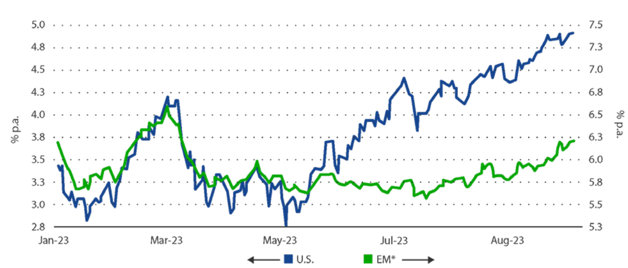
Catalyst	Status
Fed done hiking	Not so fast. NFP shows ongoing strength and market may need to price more hikes.
2/30 steepness	Still inverted. Need steepness as a minimal condition. The premium is insufficient and G-10 economists face an analytical block when trying to assign credit risk to the US. Their models will always show US term premium as too high.
USD rally	The big dollar (DXY) has lagged the sell off in Treasuries. More dollar strength to come. This is a challenge for high-beta EMFX, even if it is attractive fundamentally.
EM rates selloff	Asian and European rates minus US rates are at record lows. EMEA is challenged by inflation. If these central banks have to change course and hike, that will be a hiccup at least.
Powell put?	We hear many placing the bar for a bottom as the Powell put being re-stated. It is way too early to be thinking about this and the data just aren't there.
Stock market crash?	This is good news? This may be a turning point for US rates and even the long end of the yield curve. But, howis this good for US credit spreads? And, if economic growth is challenged globally, even EM fundamentals couldbe challenged.

Source: VanEck.

Amid the panic, we are getting more constructive – yet again EM debt is being battered by DM problems, not EM problems, and for the past decade that has been a buying opportunity for us. EM debt has outperformed the Global Agg this year and for the past three years. We think it's possible the only catalysts required are for markets to find their levels and the likelihood that the Fed is done hiking to settle in. VanEck's Emerging Markets Bond portfolio manager has been in markets for 30 years. Very superficially, the global macro story of the last 30 years is as follows. For the first 15 of those years, all global crises were EM-generated. But for the past 15 years, all global crises were DM-generated.

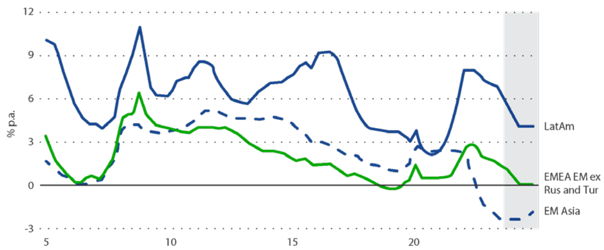
Where to go? Is local currency attractive? Look at the exhibit below, which shows US rates markets pricing in much more policy tightening than in EM in the recent period. EMs were rightly rewarded by their tight policy stances, but starting around May, the US started pricing in much more tightness that was not met with tightness in EM markets. This is consistent with our reductions in EM local currency this year. The next exhibit shows that within EM, only Latin America offers cheapness. But there we are faced with the big benchmark names' (Brazil, Mexico, Colombia, Chile) beta. Remember, "the turn in rates is not the turn in risk", so staying out of the way and our eyes on the radar remain the stance. Staying with that regional rates chart, look at Asia. Rates are at all-time lows. These were stalwarts in our portfolio last year, but we've avoided them largely and still do. We've shown this chart focusing only on China's currency, and it paints a similar picture (though China's interventions to stabilize the yuan are meaningful and credible). And charts we've produced in previous monthlies show that investment grade spreads are tight, as are high yield corporate spreads, especially given their potentially illiquidity, if outflows are on the way. **Where to go is the right question, we're not seeing answers yet.**

Exhibit 2 – EM Market Pricing of Policy Rates Lagging US Now



Source: J.P. Morgan, Bloomberg Finance L.P. *Excludes China, Russia, and Türkiye.

Exhibit 3 – Asian and European Rates Minus US Rates at All-Time Lows



Source: J.P. Morgan.

Exposure Types and Significant Changes

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

- We increased our local currency exposure in Thailand and Malaysia. Both countries are expected to benefit from China's growth rebound as authorities stepped up policy support in recent weeks. Thailand's technical test score looks particularly strong as the baht underperformed most regional peers, in part because the expected increase in tourist arrivals from China was pushed forward by several months.

- We also increase our hard currency quasi-sovereign and corporate exposure in China. China's data flow improved lately as the past policy stimulus is filtering through, including real estate developers. Our exposure is to a very selected group of corporate names, which had exceptionally attractive valuations and stand to benefit the most from the recent support package (and as a result, from the improved policy test score).

- Finally, we increased our hard currency corporate exposure in Turkey and hard currency sovereign and quasisovereign exposure in Oman. Oman continues to benefit from higher oil prices, using this windfall to implement fiscal consolidation and other structural reforms. This resulted in Oman's sovereign rating upgrade by Fitch and S&P. In terms of our investment process, these developments improved Oman's economic and policy test scores for the country.

- We reduced our local currency exposure in South Africa and the Czech Republic. Unlike its Central European peers, the Czech national bank remains hawkish - keeping its policy rate on hold at the last meeting - but we are concerned that the market will not be able/willing to discriminate, and Czech bonds will be swept away with the rest of the region if the market sentiment continues to deteriorate on the back of the greater global uncertainty. In terms of our investment process, this worsened the country's technical test score. As regards South Africa, it is difficult to find new catalysts to support a large local position there, especially as the stronger Q2 growth narrative is wearing out. We think that South Africa's energy production story might become such a catalyst later in the year, in which case we will revisit our local exposure there.

- We also reduced our local currency exposure in Indonesia and Brazil. Bonds in both countries performed well so far this year, and valuations now look less attractive. In the environment, when EM local debt's sell off is often driven by factors that have nothing to do with specific countries or credits - worsening the technical test scores - we thought it prudent to take profits and reduce exposure for now.

- Finally, we reduced our hard currency sovereign exposure in Mexico. Mexico's external position remains solid, and remittances are exceptionally strong. However, we are concerned about the government's pre-election spending plans and their impact on the budget deficit's size - and as a result, on the country's policy test score.

Source: VanEck, Bloomberg.

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