Developed Markets Face Greater Political Risks Than Emerging Markets

By Eric Fine, Portfolio Manager

VanEck Emerging Markets Bond Fund

USD R1 Inc: IE00BYXQSJ74
USD I1 Inc: IE00BYXQSF37
USD I2 Inc: IE00BYXQSG44
EUR Hedged I1 Inc: IE00BYXQSD13
EUR Hedged I2 Inc: IE00BYX22V58

Fund Review

The VanEck Emerging Markets Bond UCITS (Class USD I1) returned 0.32% in June compared to a return of -0.23% for the 50/50 JPMorgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM) local currency and the JPMorgan Emerging Markets Bond Index (EMBI) hard-currency index.

Average Annual Total Returns (%) as of 30 June 2024

	1 Mo	3 Mo	1 Yr	3 Yr†	Life†
USD R1 Inc (Inception 12/06/14)	0.28	0.44	4.85	-0.55	0.34
USD I1 Inc (Inception 20/08/13)	0.32	0.57	5.38	-0.02	2.31
USD I2 Inc (Inception 20/08/13)	0.33	0.59	5.48	0.08	2.43
EUR Hedged I1 Inc (Inception 06/10/15)	0.19	0.16	3.45	-2.08	1.59
EUR Hedged I2 Inc (Inception 22/08/17)	0.17	0.15	3.53	-1.95	0.27
50% GBI-EM/50% EMBI - USD[1]	-0.23	-0.66	4.91	-2.88	1.69

Past performance is no guarantee for future performance. Investing is subject to risk, including the possible loss of principal. The performance is based on complete 12-month periods. The return may increase or decrease as a result of currency fluctuations. You cannot directly invest in an index.

†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

The decades-old story of emerging markets (EM) bonds outperforming DM continued in the first half of the year. During June, the Fund increased local currency exposure in Mexico. Initially, the Fund had a significant underweight in Mexico local currency, but established a long position after the market was crushed by the country's June election outcome. The Fund was also significantly underweight Brazil local, which also fell sharply in June. We are currently exploring a potential tactical long position in Brazil local currency debt. We continue to favor duration as well as selected emerging markets currencies (EMFX), now including many of the high-betas (South Africa, Colombia, Hungary, Chile) following their weakness (Mexico, Brazil). Carry is 7.4%, yield to worst is 8.9%, duration is 6.8 and local makes up around 53% of exposure.

Exhibit 1 shows EM bonds continued outperformance of DM bonds in 2024 as well as over the past 7 years (in earlier pieces we take these tables back decades and get the same result, and we've done volatility-adjusted research pieces, too, of course). The exhibit also highlights that an active approach like ours can boost returns over that of the EM benchmark (which has consistently beaten DM bonds).

Exhibit 1 – EM Continues to Outshine DM Bonds

As of June 30, 2024	1H'24	2023	2022	2021	2020	2019	2018	2017	7Years
50%JPM GBI-EM GD and 50%JPM EMBI GD	-0.72	11.92	-14.75	-5.32	4.02	14.31	-5.15	12.74	0.75
Bloomberg Global Aggregate TR USD	-3.16	5.72	-16.25	-4.71	9.20	6.84	-1.20	7.39	-0.45
ICE BofA Gbl Brd Mkt TR USD	-3.33	5.56	-16.87	-5.24	8.94	6.85	-1.09	6.95	-0.72
FTSE Treasury Benchmark 10Yr USD	-1.99	3.54	-16.65	-3.51	10.37	8.85	-0.02	2.13	-0.28

US political risk is beginning to drive US rates, whereas EM always pays a risk premium for perceived political risk. The US yield curve steepened after a recent boost to former President Trump's re-election prospects. The important observation is that political and policy risks are continuing to drive asset prices in the developed markets, to now include the US. Also, we believe this recent bear steepening reaction is not correct. This bear steepening reaction to former President Trump's improved election prospects is supposed to be due to likely fiscal stimulus or heightened concern. We worry that too much of market participants' reactions are not focused purely on policy. Let's look only at economic policy, positing trade, fiscal, monetary, and structural policy as the key elements. We "table" it out

below, as we remain stunned by how unwilling many market participants are to engage with political facts, whether welcomed or not. Our conclusion is that on trade, fiscal, and monetary policy, both Trump and President Biden are equally "market friendly" (or unfriendly), with Trump maybe having an edge, (but we rate the difference 'Meh'). Structural policy (i.e., taxation and regulation) is where the key differences are, with a Trump de-regulation effort obviously holding the prospect of boosting productivity and growth. And, supply-side economic thinking would also note that higher growth is the easier answer to any fiscal issues, maybe upgrading Trump's grade. *The big problem is – so what if this is true?* We won't list the ongoing risks as we head to US elections in November, but we think the market needs to actually get through all of these before it looks dispassionately at policy…and we agree, it's too early to look through the election itself. So, if the politics are still up in the air and too far away, what does that leave us with? It leaves us with data-dependency. And the data are clearly weakening, as Fed Chair Powell noted during his Sintra comments in early July. So, we'll continue to defer to the data, which we think will have the Fed cutting in September or November. But we'll be respectful of price action, as there are clearly binary views on politics at least, if not on policy. What happens after that (likely recession fears and fiscal fears as a result), is still too early for the market to discount, in our view. One step at a time, but we are not covering our eyes.

Exhibit 2 – Economic Policy Over Politics: Trump or Biden "Market Friendly"?

	Biden or Trump the "Market Friendly" Winner?	Comment/Implication
Trade Policy	Meh	Who can be more anti-China is the new political game
Fiscal Policy	Meh/Trump	Trump's fiscal boost was during Covid, Biden's during post-Covid expansion, arguably making Trump better on Fiscal
Monetary Policy	Meh/Trump	Biden's Fed appointments have not been inflation hawks
Structural Policy	Trump	De-regulation and tax cuts boost productivity/growth and encourage

Political risks in DM are bigger than those in EM. French snap elections raise the prospect of a divided government that will likely resurrect fiscal concerns to a highly indebted sovereign in a euro zone currency union that escaped its crises about a decade ago without fixing its core deficiencies. Comments from Germany's finance minister questioning potential ECB support for the French bond market underscore the risks in France. For what it's worth, your author is French-born and has worked as a security-cleared US official in Paris, during the country's last cohabitation government (the only claim is of comfort and experience, not certitude). That DM situation is more fraught than hyped political risk in Mexico and South Africa, in our view. Probably self-evidently. Just to get one basic economic fact out of the way – Mexico and South Africa have floating exchange rates with independent central banks, and most of their debt is in their own currency. That can't be said of France is basic, so please don't forget it. (And don't forget that the currency union is still not backed by a fiscal or financial union.) A floating exchange-rate absorbs these problems, and recently looks like it did so in Mexico (where we owned none, but bought after the natural and healthy financial market reaction). This is not an existential moment for Mexico, where the incoming government has already committed to orthodox fiscal targets and appointed an excellent finance minister. Mexico was just crowded and mispriced, but it's not on the edge of an abyss. In South Africa the story is easier. Financial news made the initial headline the ANC's loss of its 50% majority, when in reality market professionals were only debating a range of 39%-41%. Anyway, the reality was always going to be a coalition government and the market got its dream outcome of an ANC alliance (through a Government of National Unity) with the very market-friendly DA. This is simply a good outcome (whatever the country's longerterm prospects). The story is easier because the South African rand is actually up against the US Dollar year to date.

Exhibit 3 – France: Another DM to Worry About That Isn't Japan or US

Source: Bloomberg. As of July 3, 2024

Geopolitical risks continue, challenging DM but creating opportunities for EM. Ongoing supply risks support commodity prices. And central banks continue to diversify their reserve assets to include safe EMs with high real rates, sustainable fiscal, and no sanctions risk (central banks aren't only replacing US treasuries with gold). None of this is new. We will repeat two things. First, the correct lens for the two hot geopolitical conflicts in Europe is NATO vs. Russia (not Ukraine vs. Russia) and Israel vs. Iran vs. Turkey (not Israel vs. Hamas or Hezbollah); you have to look at the right "thing", and these "things" are escalating. Second, an "obvious to us" scenario that seems to get no attention is that in the NATO vs. Russia conflict, Odessa is now likely "in play". Given the absence of any peaceful solutions (the Swiss peace conference and following G7 meeting were about broadening sanctions against those with links to Russia), Russia is likely to table its latest offer of freezing the current conflict and resume its grind westward. This will likely remind markets of geopolitical risks, particularly given the importance of Odessa to grain exports (Odessa is Ukraine's main port along with Mykolaiv. Just look at Odessa on the map below. We think an Odessa that escapes the conflict is likely faded.

Exhibit 4 – Odessa

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions in June were South Africa, Thailand, China, Indonesia, and Poland:

- We increased our local currency exposure in Poland and Hungary. Poland remains the cleanest disinflation and policy story in Central Europe with potential growth upside. These factors improved the policy and economic test scores for the country. Hungary's central bank is slowing the pace of rate cuts, while Europe's growth outlook is improving relative to the US. In terms of our investment process, this strengthened Hungary's policy and technical test scores.

- We also increased our local currency exposure in Mexico and South Africa, and hard currency sovereign exposure in South Africa. The market's initial interpretation of the election results was extremely negative. This view was challenged by the subsequent moves of President-elect Sheinbaum, including the new cabinet's technocratic lineup and Sheinbaum's commitment to sharp fiscal consolidation. Further, given that the pre-election positioning was predominantly long, Mexico's local rates and the currency sold off a lot after the elections significantly improving valuations. In terms of our investment process, this improved the policy and technical test scores for the country. South Africa's post-election journey was somewhat similar, with the market taking some time to warm up to the idea of the government of national unity (and the continuation of reforms and fiscal discipline). Once this happened, local rates and the currency staged a rally, explaining a big part of the increase in our exposure. These developments improved South Africa's policy test scores.

- Finally, we increased our hard currency sovereign exposure in Qatar, the United Arab Emirates, and Saudi Arabia. The key argument here is that longer duration should do better with the softening U.S. growth outlook. In terms of our investment process, this improved the technical test score for these countries.

- We reduced our local currency exposure in Brazil and Chile, and hard currency sovereign exposure in Argentina. The key concern in Brazil is growing uncertainty about the pace of fiscal consolidation and the new governor of the central bank, who might be more inclined to follow President Lula's pro-growth policy "suggestions". This resulted in the worsening policy test score for the country. Chile might be affected by China's slow recovery progress and limited policy follow-through after big initial statements, which poses risks to copper prices. Further, the

narrowing policy differential with the U.S. if the central bank continues to cut rates can put more pressure on the currency. In terms of our investment process, this worsened the policy and technical test scores for the country. We took profits in Argentina as the policy momentum is stalling – especially the approval of the watered-down omnibus bill and the central bank's failure to capitalize on good harvest and boost international reserves. These factors worsened the policy test score for Argentina.

- We also reduced our hard currency sovereign exposure in Nigeria, Suriname, and Ghana. We took profits in Nigeria, as the government is figuring out how to proceed with policy adjustment and reforms. The key concern in Suriname is domestic politics, which might get noisy in the runup to the presidential elections. We also see limited upside in Ghana in the run-up to the elections. In terms of our investment process, this worsened the policy test scores for these countries.

- Finally, we reduced our local currency exposure in Peru and hard currency quasi-sovereign exposure in Singapore. We used these positions as funders for other more interesting opportunities. Peru might be affected by a slow pace of China's recovery (which might weight on copper prices), and the narrowing policy rate differential with the U.S. In addition, there is a risk of contagion from the "bad LATAM" regional story. These factors worsened the technical test score for the country.

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- **Emerging Market Risk:** In emerging markets, the legal, judicial and regulatory infrastructure is still developing and there is much legal uncertainty both for local market participants and their counterparties. Investments in these countries may involve specific political, economic and financial risks that have a significant impact on valuations and liquidity of those investments. They are also exposed to additional risks that are difficult to calculate and would not arise with investments made in OECD countries or other emerging markets.

- **Currency Risk:** Some of the Fund's assets can be invested in currencies, other than the Fund's currency. The performance of the Sub-Fund can be subject to elevated volatility on the downside as well as on the upside due to currency fluctuations. Northbound investments by the Fund in the Bond Connect Securities will be traded and settled in Renminbi / RMB, the official currency of China. The RMB is currently not a freely convertible currency.

- **Credit Risk:** The Fund will invest in bonds that are subject to varying degrees of risk that the issuers of the securities will have their credit ratings downgraded or will default, potentially reducing the value of the securities.

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