Manager Commentary

Tailwinds and Headwinds in Emerging Markets Debt

By: Eric Fine, Portfolio Manager

Executive Summary

- Real interest rates and credit spreads are high in a number of emerging markets.
- Even some countries with unimpressive overall policy frameworks have allowed currency weakness and hiked interest rates.
- Rising growth levels in developed markets continue, however, to attract money away from emerging markets.

Average Annual Total Returns (%) as of 31 January 2014

	1 Mo*	3 Mo	YTD	Life
USD I1 Acc (Inception 20/8/13)	-2.09	-3.77	--	2.65
USD I2 Acc (Inception 20/8/13)	-2.08	-3.75	--	2.70
GBI-EM Index	-4.63	-8.61	--	-4.14
EMBI Index	-0.68	-1.88	--	2.79

*Monthly returns are not annualized.

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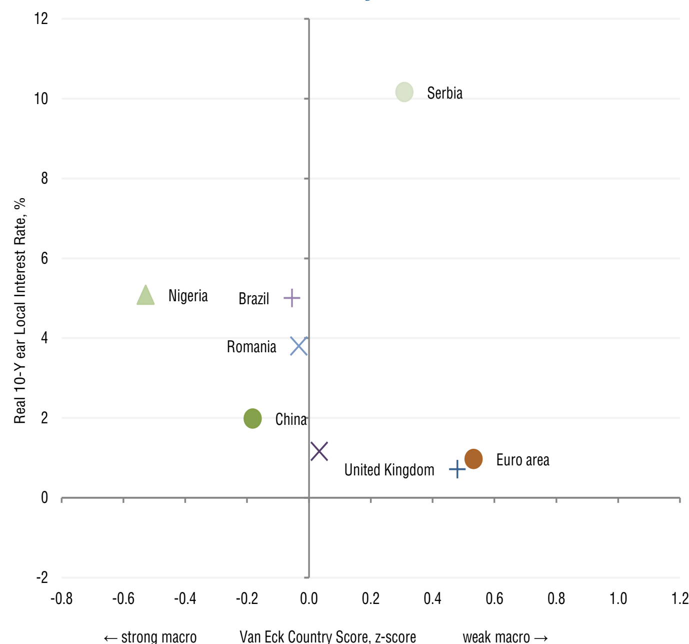
Fund Performance

For January, Class I1 shares of the Unconstrained Emerging Markets Bond UCITS (the "Fund") returned -2.09%, compared to -4.63% in the local-currency index (GBI-EM Index), and -0.68% in the hard-currency index (EMBI Index). The Fund's biggest winners in January were Portugal (hard-currency), Sri Lanka (local-currency), and Indonesia (local-currency). The Fund's biggest losers were Argentina (hard-currency), Hungary (local-currency), and Chile (local-currency). The market's best performers during the past month were Belize, Jamaica, and Egypt in hard-currency, and China, India, and Thailand in local-currency. The markets' worst performers of the past month were Argentina, Venezuela, and Ukraine in hard-currency, and South Africa, Russia, and Hungary in local-currency.

Overview

Let's start with a tailwind: real interest rates and credit spreads currently are high in a number of emerging markets (EM). The charts below show a sampling of EM real interest rates and credit spreads compared with a sampling of developed markets (DM) real interest rates and spreads (on the y-axis). On the x-axis is our country score. (This is not too different from a credit rating: our inputs are variables such as the country's balance of payments accounts, fiscal accounts, financial sector health, etc.). The point of these charts is that, in our opinion, one generally gets paid more for EM risk than for the same level of DM risk.

Exhibit 1 - Real Rates and Country Score: EM versus DM



Source: Bloomberg, Van Eck research. Data as of January 31, 2014.
Z-score is a statistical measure of how close a data point is to a data set's mean.

Another tailwind: EM policy has responded, and much of the policy response is a "simple" function of flexible exchange rate regimes, not really requiring politicians to be pro-active or even to take "action". To explain. In the first phase of the EM mini-crisis that started in May/ June of 2013, the market focused its (negative) attention on countries with large current account deficits. The immediate response of policymakers in Brazil, India, and Indonesia was, technically…nothing. Flexible exchange rate regimes mean that if the market chooses to be concerned about external imbalances, the currency adjusts – period. (We're simplifying, but, we believe, not too much.) Imports are curtailed (which is, in our experience, the normal and more dramatic initial effect), and, as a result, exports are potentially boosted.

Please note that the information herein represents the opinion of the portfolio manager and these opinions may change at any time and from time to time.

Now, in some countries, inflation memory exists, so weak currencies can potentially feed through into rising inflation expectations. So, a logical follow-on policy may be higher interest rates. This has tended to stabilize the currency (ceteris paribus), encourage savings, and slow the economy down…reducing inflationary pressures, as well as imports. Even countries whose overall policy frameworks do not impress us, and which we do not own – Turkey, South Africa, Ghana, to name a few – have adjusted to the market's concerns and allowed currency weakness and hiked interest rates. (However, in our opinion, just not enough.)

Even supposedly heterodox Argentina has been forced by the market to allow greater currency weakness and has allowed much higher domestic interest rates…perhaps the best policy we've seen from the country in many years. In particular, the currency has been allowed to sell off by 20% since the beginning of the year, and interest rates (as measured by the central bank's Lebac bills) have risen by 900 basis points. This combination is very powerful, in our opinion, for the reasons explained above. After these moves, the country could potentially begin to see an increase in hard-currency reserves at the central bank. Moreover, it appears to be freeing up frozen resources in the agriculture sector. Farmers are estimated, by local analysts, to have up to $4 billion worth of unsold soybeans. Before the adjustment in the exchange rate, their thinking may have been: "We'll wait 'til we can get more pesos for our beans because we think the peso is too expensive." After the currency adjustment, their thinking appears to have been: "We'll wait because we think you'll have to devalue more." After the rise in interest rates, however, the response looks to be: "We'll sell our beans because we can now put our peso proceeds into peso bonds with high yields." The country's cabinet chief recently announced that soybean farmers have committed to sell $2 billion of soybeans as a result of these moves, which would further boost reserves.

One key headwind remains that the DM, particularly the US, is experiencing rising growth levels, whereas the EM is experiencing lower growth. This could attract money away from the EM and into the DM. EM debt and equity markets have seen outflows every week so far this year – dramatically so in equities. Moreover, the "good" policy we praise above may preserve reserves and keep the balance sheet strong. But it does hurt growth, exacerbating this money flow.

Another key headwind is that the EM debt market community may not be as aware of corporate borrowing activity as it should be. Key countries may have more corporate debt in hard-currency than conventional econometrics would indicate. Traditionally, market participants use national central bank balance of payments data to determine corporate debt issuance. The standard practice for central banks has been not to count corporate debt issued by an overseas subsidiary of a domestic company. (You might recall this issue arising in the European debt crisis, when Irish debt turned out to be much larger than commonly understood, because much of it was bank debt issued offshore in, say, Luxemburg, and which was accounted for as Luxemburg debt). Anyway, this issue is now getting more attention (Lord Turner of the Bank for International Settlements has written a recent paper on the topic), and rightly so.

Exposure Types and Significant Changes

As an ongoing reaction to these developments, we continued to do two things in the portfolio – diversify and increase exposure to hard-currency debt (and, thus, reduce exposure to local-currency debt). We never really got to the "So what?" of our point above that some EM countries have allowed currency weakness and hiked interest rates. The "So what" is that this protects hard-currency reserves that are used to pay hard-currency debt.

Our top five positions are currently: Argentina (in hard-currency), Brazil, Hungary, Mexico, and Indonesia (all in a mix of hard- and local-currency). Our top five country allocations are identical to last month's, with the exception of Sri Lanka (which we reduced) and Indonesia (which we increased). The bigger point, though, remains that we continued to reduce our local-currency exposure and raise our hard-currency exposure.

Biggest Country- and Bond-Level Changes

- We increased hard-currency debt substantially.
- We diversified the portfolio into a wide range of hard-currency bonds. Among them are Romania, Belarus, Serbia, Guatemala, Angola, Vietnam, and Russia.
- Although our top five country exposures were largely unchanged, Brazil, Hungary, Mexico, and Indonesia all saw reductions in local-currency exposure and increases in hard-currency exposure.

Please note that the information herein represents the opinion of the portfolio manager and these opinions may change at any time and from time to time.

Data Source: Van Eck Research, Bloomberg, Factset. All portfolio weightings and statements herein as of 31 January 2014.

Emerging Markets Hard Currency Bonds refers to bonds denominated in currencies that are generally widely accepted around the world (such as the US Dollar, Euro or Yen). **Emerging Markets Local Currency Bonds** are bonds denominated in the local currency of the issuer. **Emerging Markets Sovereign Bonds** are bonds issued by national governments of emerging countries in order to finance a country's growth. **Emerging Markets Quasi-Sovereign Bonds** are bonds issued by corporations domiciled in emerging countries that are either 100% government owned or whose debts are 100% government guaranteed. **Emerging Markets Corporate Bonds** are bonds issued by non-government owned corporations that are domiciled in emerging countries. A **Supranational** is an international organization, or union, whose members transcend national boundaries and share in the decision-making. Examples of supranationals are: World Bank, IMF, World Trade Organization.

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Bonds and bond funds will decrease in value as interest rates rise.

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