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Global economic perspectives

April 2020

Market review

The last quarter seems like something out of a science fiction movie. A virus pandemic, an oil crisis, financial market capitulation, toilet paper hoarding and the media's, particularly social media, ubiquitous coverage and unrelenting focus on the negative. What is missing in the background to this movie is a score to match, it appears Mozart's Requiem in D Minor would be fitting. It's no wonder many people feel like we are in the eye of the financial storm where liquidity reigns as king and there is no place to hide but cash. The pandemic has led to a credit crunch where corporate earnings and cash flow are the centre of the current liquidity predicament.

We live in a highly interconnected and globalised world. The COVID-19 pandemic is bringing about an unprecedented economic halt to all productivity. The market crash deemed a 'black swan' event has not been isolated to equities but also to credit and bond markets. The lack of a reliable asset to hedge is unprecedented. In the early stages of the pandemic, investors piled into government bonds however yields climbed erratically and the pursuit to a safe harbour was limited.

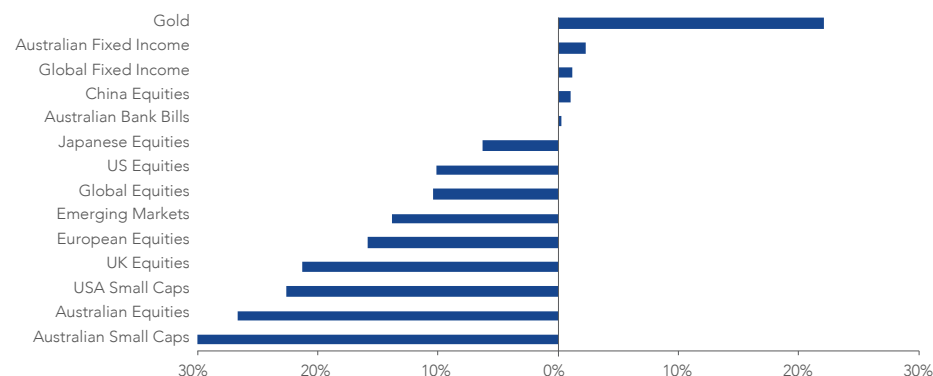
For the quarter 27 March 2020, gold bullion (in Australian dollar terms) led the charge as investors sought protection. Ironically in the place where it all started, Chinese equities have outperformed developed markets and offered absolute positive returns. It was no surprise to see that both in Australia and globally the best performing sectors were consumer staples and healthcare.

The current monetary stimulus efforts by central banks – including but not limited to the Reserve Bank, ECB, Bank of Japan and the US Federal Reserve – combined with the fiscal stimulus by most governments is aiming to thwart the impact to businesses and households. These are uncharted waters as we navigate the eye of the financial and health storm upon us. We are yet to reach 'peak pandemic' and only with time and the benefit of hindsight will we be able to assess the true devastation of the destruction of wealth and human loss. Investor's constitutions are being tested like no other time.

"Without courage, all other virtues lose their meaning."

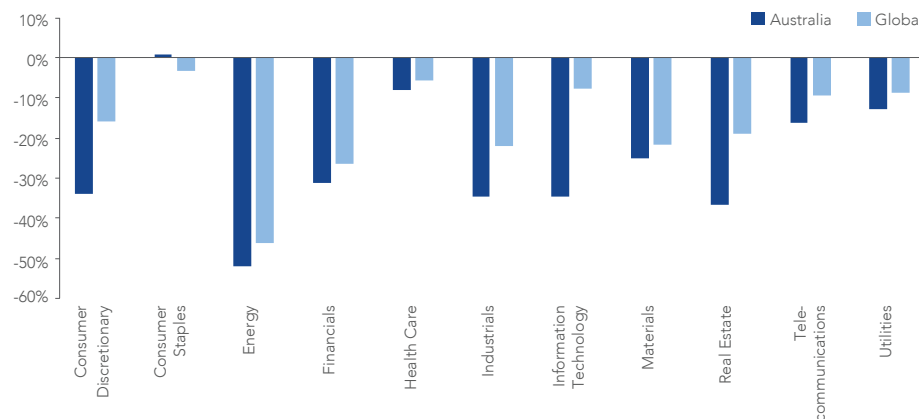
– Winston Churchill

Chart 1: Index returns in the March 2020 quarter



Source: Bloomberg, 1 January to 27 March 2020, returns in Australian dollars. International Equities is MSCI World ex Australia Index, Australian Equities is S&P/ASX 200 Accumulation Index, Australian Fixed Income is Bloomberg AusBond Composite 0+ yrs Index, Global Fixed Income is Bloomberg Global Aggregate Bond Hedged AUD Index, Australian Bank Bills is Bloomberg AusBond Bank Bill Index, Emerging Markets is MSCI Emerging Markets Index, Gold is Gold Spot US\$/oz, Australian Small Caps is S&P/ASX Small Ordinaries Index, US Small Caps is Russell 2000 Index, US Equities is S&P 500 Index, UK Equities is FTSE 100 Index, Japanese Equities is Nikkei 225 Index, European Equities is MSCI Europe Index, China equities is CSI 300 Index.

Chart 2: Global and Australian equity sectors March 2020 quarterly performance



Source: Bloomberg, 1 January to 27 March 2020, returns in Australian dollars. Consumer discretionary is MSCI World Consumer Discretionary Index / S&P/ASX 200 Consumer Discretionary Index, Financials is MSCI World Financials Index / S&P/ASX 200 Financials Index, Materials is MSCI World Materials Index / S&P/ASX 200 Materials Index, Healthcare is MSCI World Health care Index / S&P/ASX 200 Health care Index, Utilities is MSCI World Utilities Index / S&P/ASX 200 Utilities Index, Property is MSCI World REIT Index / S&P/ASX 200 AREIT Index, Consumer Staples is MSCI World Consumer Staples Index / S&P/ASX 200 Consumer Staples Index, Information Technology is MSCI World Information Technology Index / S&P/ASX 200 Information Technology Index, Energy is MSCI World Energy Index / S&P/ASX 200 Energy Index, Industrials is MSCI World Industrials Index / S&P/ASX 200 Industrials Index, Communications is MSCI World Telecommunications Index / S&P/ASX 200 Telecommunications Index.

Black Swan time

Back in December, markets were on a tear. Global growth, led by the US, was heading in the right direction. Good news was taken to heart and fully priced, bad news was discounted or ignored. Hindsight is a marvelous thing, but hubris often precedes payback!

While always cognisant that good times do not last forever, parts of the equity markets appeared to be overvalued and corporate balance sheets and corporate debt were not in great shape. We'd also expressed concern about global, just-in-time, supply chains in the then trade-war era and its subsequent pause (remember the trade war?).

It's the definition of Black Swans that you don't see them coming. Two have sailed into view: COVID-19 and an oil shock. In some ways they offset, in others they amplify. And it's early days to have clarity on how big or how long-lasting their impact will be.

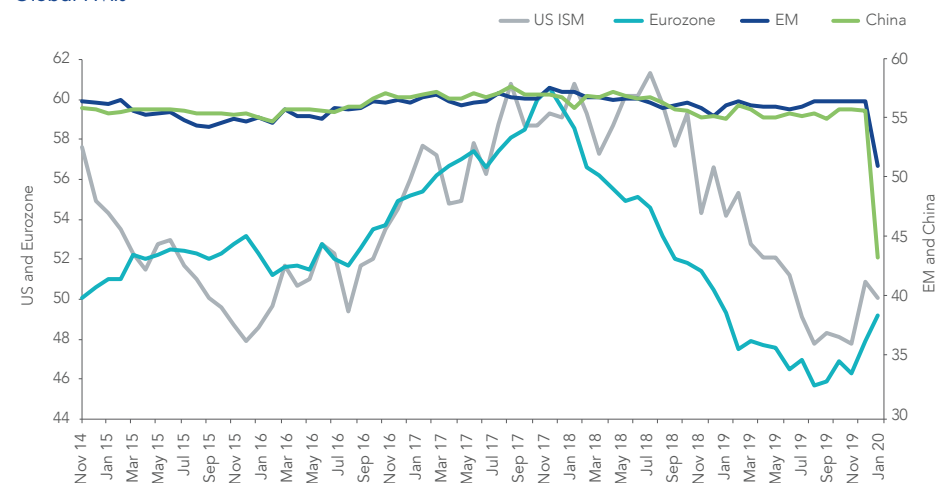
Any action central banks take to stimulate a weakened economy is likely to lack impact in the short term. There are two aspects that make a coronavirus economy extremely difficult to stimulate. First, this is a deflationary shock with declines or stoppages in work, travel, leisure and other forms of economic activity. Second, it is likely to create shortages due to the interruption of global supply chains, which would normally be inflationary. No amount of rate cuts or quantitative easing will have much impact until people and businesses are able to resume normal activities.

At this stage, markets are caught in a risk unwind, which in turn has unleashed a value at Risk (VAR) storm and a classic liquidity squeeze. How far and how long markets stay unhinged will depend on the quality and quantity of the policy response and how quickly the world shakes off COVID-19.

While we remain positive the impact of COVID-19 will be short-lived, talk of a rapid V shaped recovery by mid-year might be too optimistic. There will be repercussions throughout 2020.

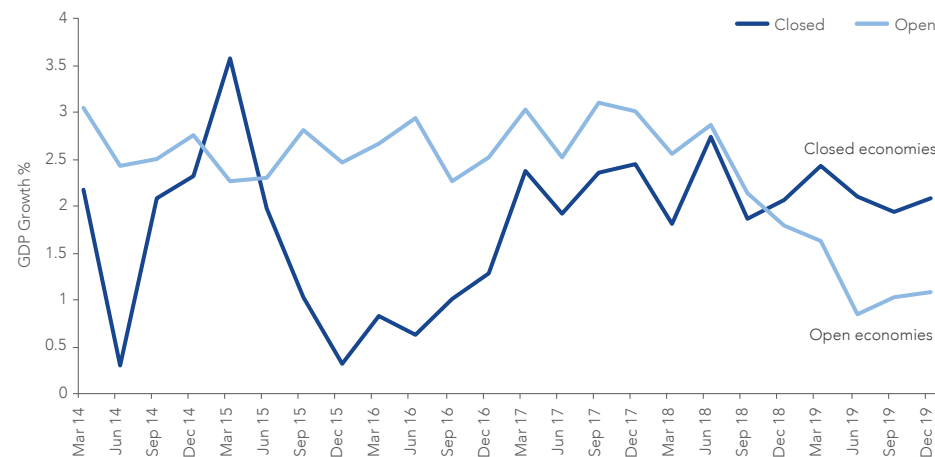
The slump in oil prices will be a supply boost for energy consumers. Though it will be more problematic for high cost energy producing nations.

Chart 3: Q4 2019 data was pointing the right direction, led by the US
Global PMIs



Source: Bloomberg LP. Data as of February 2020.

Chart 4: Trade war pause had led to peace dividends everywhere
US-China trade war and GDP growth



Source: VanEck Research, Bloomberg LP.

Global policy response

Central bankers in developed markets (DM) have landed in their nightmare scenario. They have little to no ammunition left. Cutting rates and pumping cash worked for the GFC because it was principally a financial crisis. All monetary policy can achieve this time is to provide cheap liquidity to calm markets. To date this has not helped. Programs to help companies, especially SMEs, cope with cash flow problems could be crucial.

Fiscal policy should be more potent – although not in the short term. Until the pandemic abates, most of what it can do is provide income support for dislocated individuals and companies, rather than bolster fresh spending. It needs to help ensure companies and individuals are in a position to contribute to recovery when the time comes – insolvent or chronically indebted companies or households cannot. Governments around the OECD world have, by and large, grasped this. While the first-round responses were out of the GFC playbook (an attempted modest demand boost coupled to market liquidity measures) the second-round packages have been much larger and aimed at underpinning incomes and balance sheets. But the problem of magnitude remains.

No one can say with confidence how big a response is required. With credit markets already strained (more below) and corporate balance sheets loaded, it's doubtful the liquidity measures proposed will succeed given the likely duration of the crisis. Our best guess is the crisis is likely to hit 2020 global growth by 10 per cent – a massive hit, concentrated in the second quarter which may be down 30 per cent at an annualised rate.

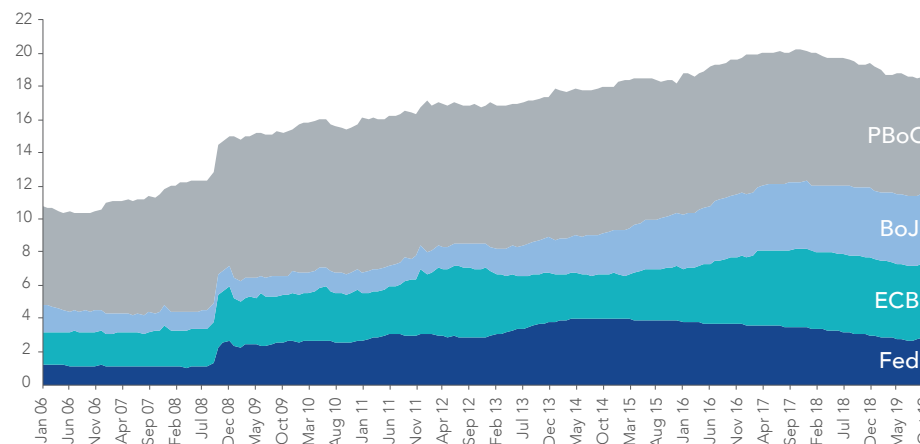
While some governments have announced packages totalling 10 per cent of GDP in dollar terms, these are, so far, over-announcements adding guarantees and liquidity facilities to actual dollars (Australia is an example of this). Given the unknowable scale of the hit, chasing valuation levels is a pretty pointless task. Markets will start to heal when the virus is clearly under control; at which point the depth of the growth, balance sheet and earnings hits will be calculable.

There appears to be nowhere to hide. Except perhaps emerging markets (EM). While these are high beta markets and will get hurt by a soaring US dollar in the short term, they may be better performers in the medium term.

At least EM policy makers have a little more room to move, so like the GFC in which China was able to be a part of the stimulus story, we expect some emerging markets again to be stronger as a result of this crisis.

Chart 5: Where the liquidity is going to come from?

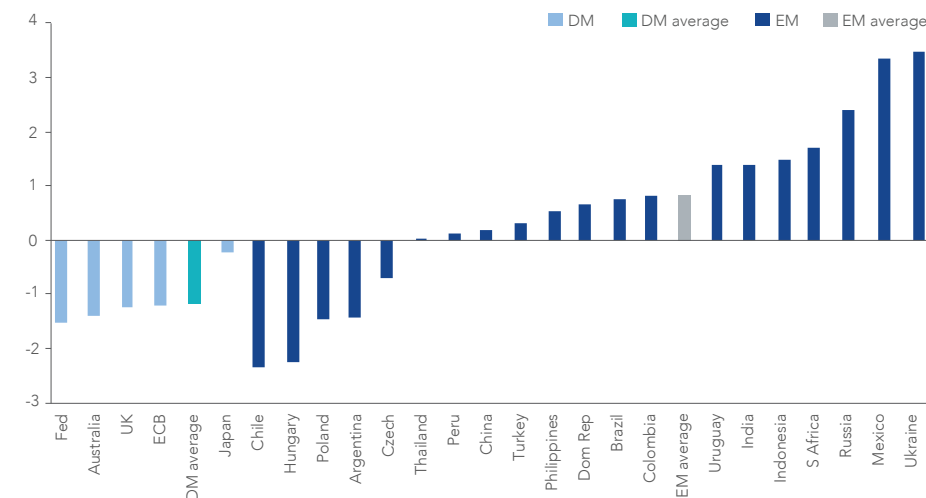
Major central banks' balance sheets (% world GDP)



Source: VanEck Research, Bloomberg LP. Data as of 28 February 2020.

Chart 6: Emerging markets had room to move before COVID-19

Real policy rates in selected EM and DM, %



Source: VanEck Research, Bloomberg LP. Data as of 19 March 2020. Nominal policy rates adjusted for 12-month ahead inflation expectations.

China

China's regime has one big advantage in dealing with an epidemic: they can issue absolute orders to citizens and companies to shut down and isolate.

They also have a serious disadvantage: information and social control. Coupled with obsessive image protection, this means that vital information to avert problems is slow to arrive. It also means outsiders are likely to be highly sceptical about any "good news".

Thus, China's response to COVID-19 was both late – and drastic. Widespread economic lockdown means economic output has plummeted, destroying production chains across the globe.

As early as the first week of March, 75% of US companies were already experiencing supply chain disruptions, according to a survey by the Institute of Supply Management (ISM). Revenue forecasts for the year had already been downgraded by 5.6% on average. This will be the tip of the iceberg.

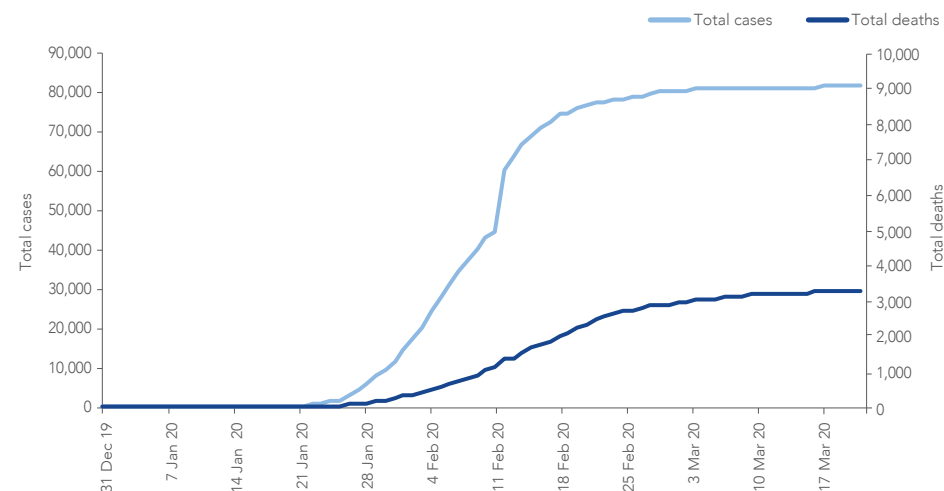
As we have mentioned previously, in respect of trade and technology tussles, the high tide of globalisation has passed. The demonstration of how fragile supply chains are will exacerbate the recoil. Blamestorming over the origins of the pandemic will exacerbate antipathy between the US and China.

According to the China National Health Commission new cases of COVID-19 in China have moderated and the sum of confirmed and suspected cases have trended downwards. Chinese are starting to return to work. The best indicator of a turnaround in Chinese output will be other countries' imports from China. This data will only be available with a considerable lag.

The supply shock is greatest in China, with food prices surging (an earlier swine flu outbreak exacerbated this). But the Chinese authorities face CPI inflation in excess of 5%, with interest rates of 1.5% for one-year deposits. Cutting rates risks stoking inflation, as well as eroding the real value of household savings. On the other hand, already burgeoning fiscal spending will likely have to be directed to supporting bloated corporate balance sheets. Nonetheless, we expect China will continue to throw policy boosts at the economy. They have little choice and they have room.

Chart 7: China's flattening curve

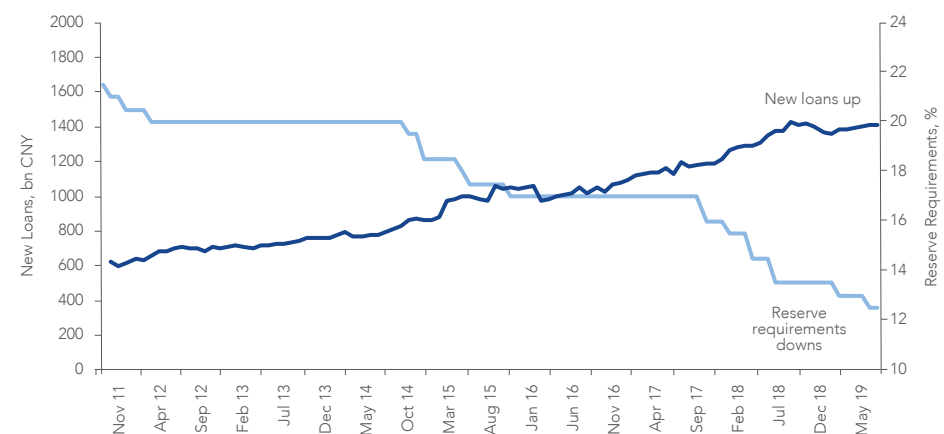
China COVID-19 cases and deaths have moderated



Source: China National Health Commission.

Chart 8: China encouraging credit

China credit aggregates, monthly changes (bn CNY)



Source: Bloomberg LP.

United States

Heading into the turn of the year, the US economy was in a Goldilocks spot: growth was moderate, labour markets were firm and wage growth was picking up. For an economy near full employment, it was about the best that could be hoped for: not too hot (which would lead to rate hikes); or too cold (sluggish growth sliding into recession).

Unfortunately, the US is now looking at the downside of both black swans. Like elsewhere, COVID-19 is hurting businesses. And, while lower oil prices will help household budgets, the US oil sector may suffer.

The longest economic expansion and bull market in history has come to an end in 2020. The Fed cut rates by 50bps as its first step and this was insufficient to prevent financial conditions tightening. As the severity of the outlook deteriorated, with rates dropped to the lower bound and the difference between QE and non-QE has now evaporated.

We believe that debt will become the foremost risk, as it has been in nearly every recession. Corporate profit growth had been stagnating ahead of earnings growth this year. Yet corporate debt is at record levels, as are the amount of risky leveraged loans.

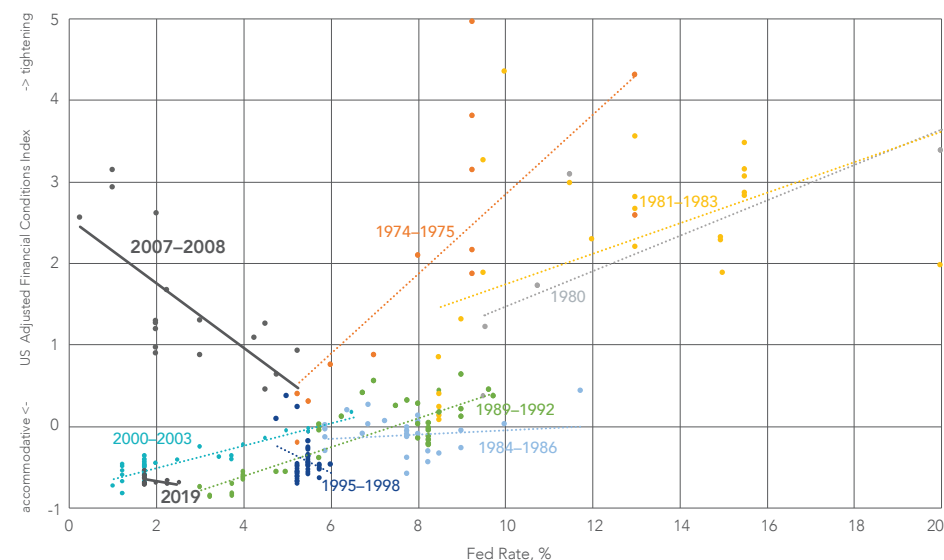
In addition, more debt is likely to be downgraded to junk status in a recession, which could force many funds to sell. Meanwhile, overwhelming levels of sovereign debt may limit government's ability to borrow and spend in a downturn. Central banks may come under pressure to monetise or print money to keep governments and businesses afloat. These are the financial risks that might drive gold higher in the next recession.

Just over half this debt sits in the BBB bucket - one notch up from the (much smaller) high yield/junk market. With corporate cash flows crimped, there is now a serious risk of downgrades, flooding the junk market and blowing spreads.

Yield spreads across IG and HY have already started moving out. A serious bout of indigestion would see rate spreads really blow. In turn, this would slam the door on buybacks - the biggest equity buyer of the past year.

Chart 9: The Fed's recent rate cuts are resulting in tighter financial conditions like in 2007–2008

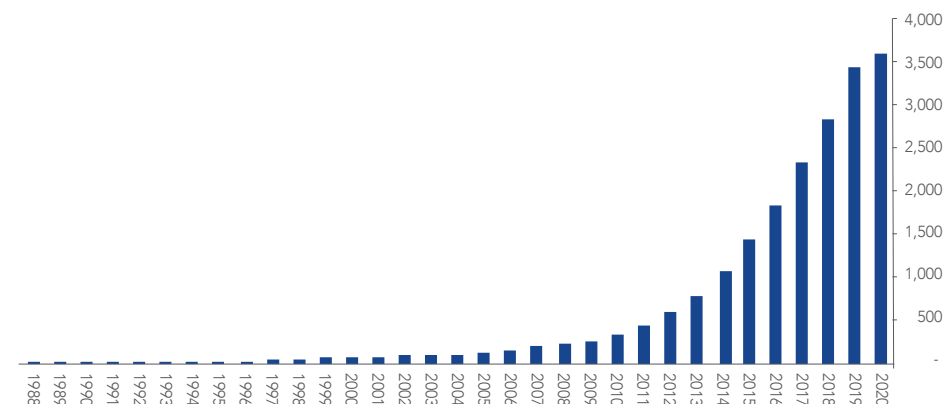
Fed's cutting cycles and US financial conditions (Chicago Fed's adjusted index)



Source: Bloomberg LP. Data as of February 2020.

Chart 10: The continued expansion of BBB credit

BBB corporate debt issued (US dollars, billions)



Source: Bloomberg LP.

Europe

The Eurozone is a weak link in the global economy. Most important, the currency zone is not optimal – one currency with many fiscal and financial systems underneath makes no sense, as is acknowledged by European officials. Crisis was supposed to provide the excuse for creating an optimal currency zone, but even the GFC and the European crises of 2013 didn't result in fixing this basic structural problem. Until this is done, there will always be doubts about longer-term sustainability of the monetary union and its currency, the euro.

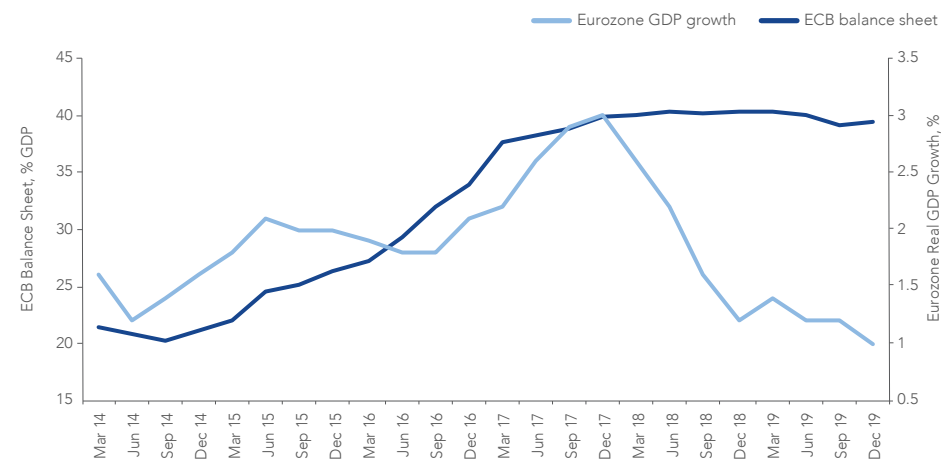
In the past couple of years, it also became increasingly clear that the Eurozone's monetary policy setup is largely exhausted in its current configuration. Even though the ECB had been actively expanding its balance sheet and lowering its policy rate – which drove the shadow policy rate to mind-boggling -7.28%, the regional real GDP growth no longer responds to the stimulus. The ECB is truly stuck:

- if it continues to cut rates further, it might irreparably damage the financial sector;
- if it tightens, this might push many European corporates over the edge.

These are the reasons that might have prompted the German government to abandon its decade-long “black zero” principle of balanced budgets and approve a fiscal stimulus package to minimize the economic damage from the coronavirus. The package is on the small side, but its significance and symbolism should not be underestimated both in terms of a near-term cyclical impact and a longer-term support for growth.

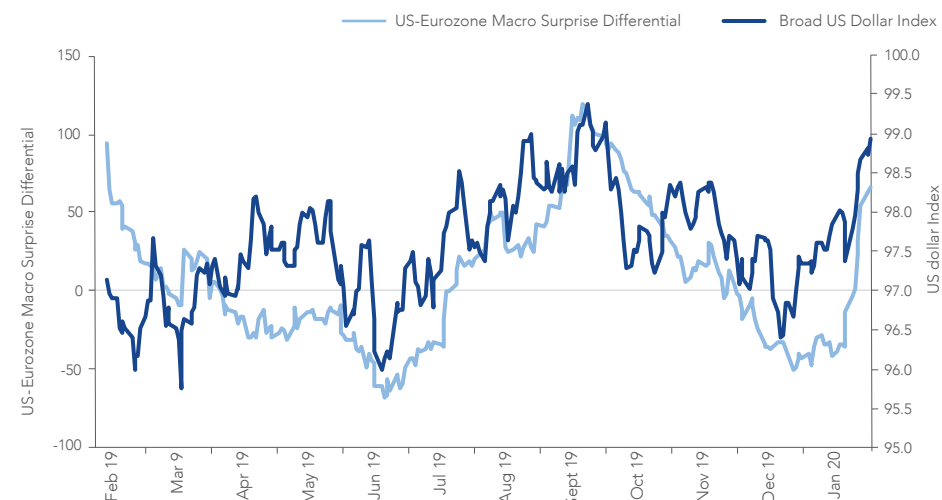
We can only hope that at some point there will be a wider acceptance of structural and institutional reforms in the Eurozone and the European Union. There were some positive country-specific examples in the past few years, but more needs to be done. For now, the region's structural and institutional rigidity (such as reliance on “national champions”) remains a major impediment to lifting its potential output beyond meager numbers that we see on a regular basis. The problem with being hopeful of further structural reforms is the fact that Europeans never supported currency union. So asking voters to pay a price during crisis, for something they never supported, strikes us as a politically fraught.

Chart 11: The ECB was maxed out before
ECB balance sheet and Eurozone GDP growth



Source: Bloomberg, February 2020.

Chart 12: Eurozone to ‘restart’ in relatively worse shape
US dollar and relative macro surprises



Source: Bloomberg LP.

Gold

While the sell-off in gold stocks was painful, it is not unusual in the middle of a stock market panic. The last such example was during the 2008 financial crisis. Following Lehman's bankruptcy in September that year, gold declined just 10% before trending higher about a month later. Over the same period in 2008, the NYSE Arca Gold miners Index fell 48%, but by December 16 it had recovered to its pre-Lehman level in a classic V-shaped recovery. Contrast this with the S&P 500 that didn't reach a bottom until 6 March 2009 after falling 46%. The S&P 500 didn't recover its post-Lehman losses until January 2011. So, while the general stock market was struggling to recover for over two years, the gold stock market quickly rebounded and went on to bull market gains.

We believe the markets will look back on COVID-19 "black swan" as a buying opportunity for gold shares. However, whether the worst is behind us is anyone's guess.

As markets gyrate, gold investors must not lose sight of the bigger picture. For over a year, falling real rates have primarily driven the gold price. With many markets in disarray amid the widening outbreak, gold has not responded to the fall in real rates. Once the volatility subsides, we expect real rates to continue driving gold prices.

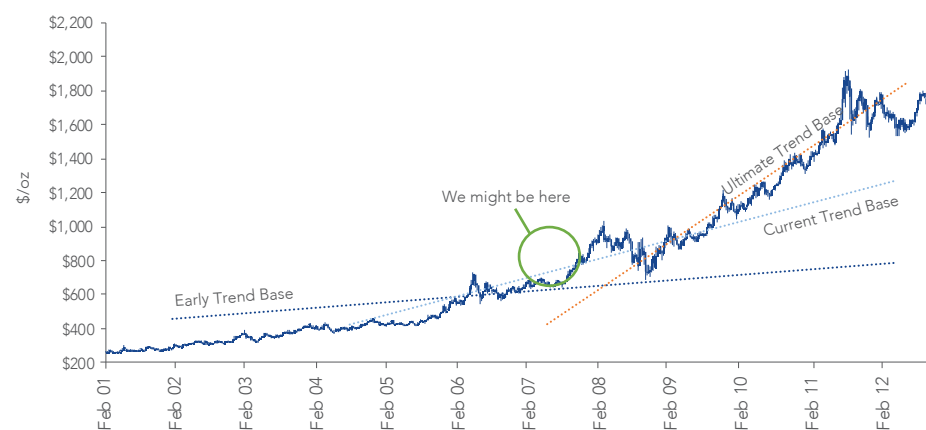
Gold and gold stocks are in the middle of a secular bull market that started in December 2015 when gold bottomed out at US\$1,050 per ounce. The two gold price charts highlight the technical similarities between the current bull run and the 2001 – 2011 rally. The top chart tracks the price trend of the current bull market. It began with a weakly rising trend for several years, then accelerated to a stronger trend in 2019. Likewise, in the bottom chart an early trend of weakly rising prices broke into a stronger trend in 2005. In the earlier market (bottom chart), the ultimate trend followed the financial crisis in 2008. The red circle shows roughly where the current market might be in the larger scheme of things, using the 2001 – 2011 market as an analogy.

Fundamentally, each of these markets had different drivers, with the early 2000s market driven by the fallout from the tech bust and US dollar weakness. The early years of the current market were driven by geopolitical risks and Fed activity. Regardless of specific drivers, both markets rose with increasing risks to the global financial system where gold was bought as a safe store of wealth.

Chart 13: Comparing bulls
Current market, 2015 to current



Chart 14: Comparing bulls
Current market similar to gold's last secular rally, 2001 to 2012



Source: Bloomberg, VanEck. Data as of 28 February, 2020. Past performance is not a reliable indicator of future performance. Chart is for illustrative purposes only.

Emerging markets bonds

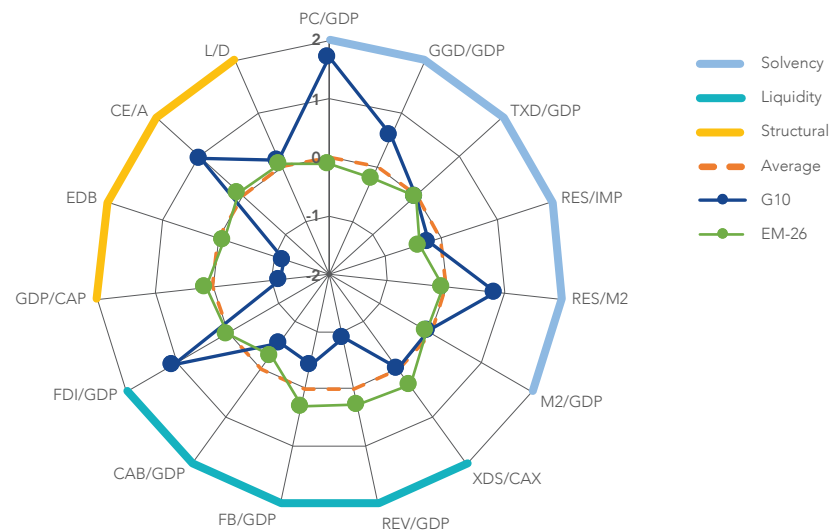
Some emerging markets look set to acquit themselves during the COVID-19 crisis, as they did during the GFC. And, for the same basic reasons – strong fiscal balance sheets, and central banks focused on maintaining high real interest rates. Emerging market economies generally have much lower debt stocks, whether private or public. For example, the biggest emerging market economies have private credit (as a percent of GDP) in line with the global mean, whereas the G-10 developed markets have private credit almost 2 standard deviations higher than the global average. We start with the example of private credit because these are the markets that remain unresolved by policymakers at this moment (more on that below).

Secondly, emerging markets central banks are very orthodox, and maintain high real interest rates, especially in comparison to those of the developed markets. Earlier in this ViewPoint, Chart 6 highlighted some of these real policy rates in emerging markets and developed markets coming into the crisis. Average emerging markets real policy rate is 0.84% whereas the average real policy rate in developed markets is -1.17%.

Of course, emerging market debt exists in the context of global markets and economies in disarray, so a necessary element of the rebound we expect in emerging markets is some end to the current crisis. We see this forthcoming in the coming weeks/months due to the incredible monetary and fiscal stimulus developed markets and emerging markets economies are enacting. We expect the US authorities, in particular, to enact forms of CE (credit easing) to address the still-unresolved issue of non-functioning credit markets. We also expect the Fed to extend its US dollar swaps with key emerging markets central banks, providing dollar liquidity and preventing vicious cycles resulting from US dollar demand. Finally, we'd note that the collapse in oil prices has been conflated with a demand shock in emerging markets, but it is really a supply shock. Lower oil prices benefit emerging markets, most of which are oil importers and have consumption baskets with a large energy component, meaning that real interest rates are higher and give policymakers that much more room to ease.

Chart 15: Emerging markets have less debt than developed markets

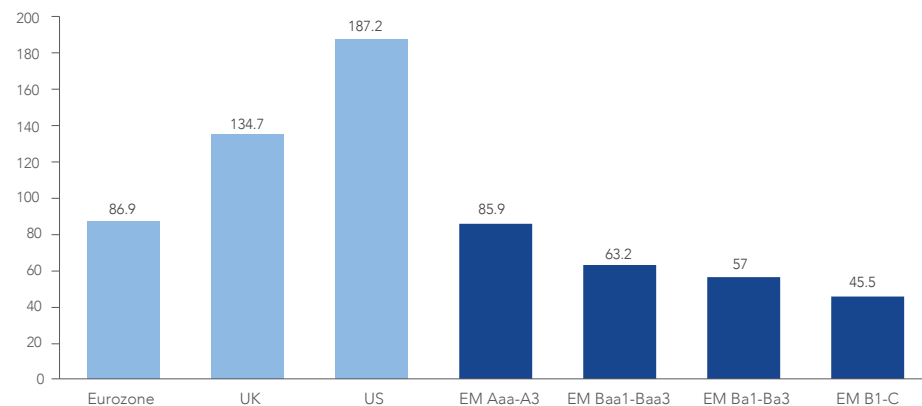
Radar chart comparing develop markets and emerging markets



Source: VanEck, Bloomberg as at end of February.

Chart 16: Emerging market's lower debt

Domestic credit/GDP Ratio (%)



Source: VanEck, Bloomberg as at end of February.

Australia's luck runs out

Australia has been skating on thin ice for a while now: private domestic demand has been close to zero, with government spending and exports keeping the economy's head above water.

Lacklustre wages growth has led to weak consumer spending, in turn suppressing non-mining investment. After earlier surges, mining investment and housing investment (notably apartments) have been unwinding. Were it to continue, the house price pick-up would see housing construction start to rebound.

Employment growth has been a highlight – although led by lower paid sectors, such as (government funded) healthcare and services – which also have lower measured productivity.

The RBA spent much of 2019 begging the Government to be proactive. The RBA was aware of how little useful ammunition it had left in its barrel. Indeed, last years' interest rate cuts had reflate the capital city house price bubble; while undermining broader confidence and interest incomes.

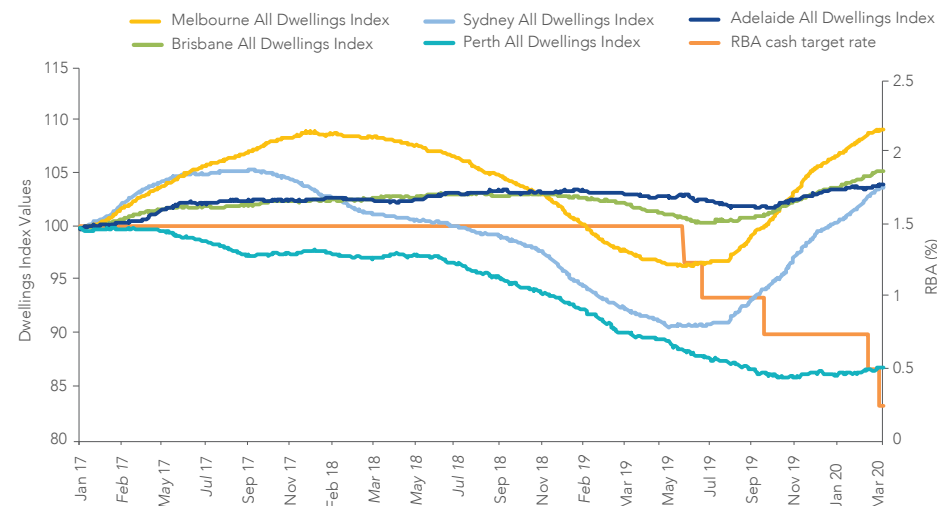
Like other central banks, the RBA felt fiscal policy was a more potent weapon. With real interest rates so low; and (in Australia's case) government debt at very low levels, there seemed no reason not to put long term productive investments in place.

Unfortunately, time ran out. Australia's luck has turned. Last year, mining problems in Brazil boosted Australian exports and national income. This year, bushfires, COVID-19 and the oil shock will do the opposite.

Education and tourism are two of Australia's biggest exports. Both have been adversely impacted by bushfires and COVID-19.

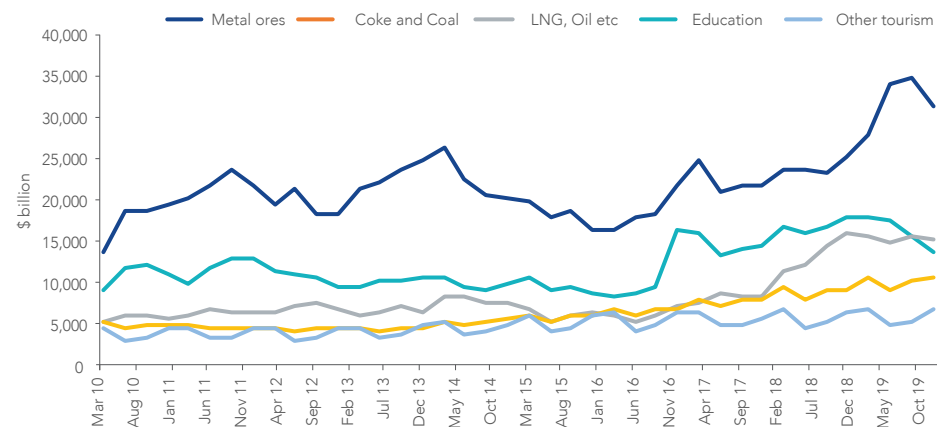
As shutdowns spread and employment and business survival gets hit, estimates of the possible short term cost to GDP are soaring, with 10% declines possible. Obviously the longer the virus outbreak continues, the greater will be the damage.

Chart 17: RBA action in 2019 had only increased house prices
CoreLogic Home Property Value Index rebased to 100 1/1/2019



Source: CoreLogic, RBA, to 24 March 2020.

Chart 18: Miner, education and tourism were major exports
Australia's top export mix



Source: ABS.

Fiscal response

The Federal Government has given up on its budget surplus obsession and has now made multiple fiscal responses. The first, weighed in at a bit over 1 per cent of GDP over the forward estimates, with more than half expected in the remainder of this fiscal year. The second looks more like 4-5 per cent – although it has been advertised as 10 per cent. Around half consists of lending, guarantees and RBA liquidity. The third is the \$130bn JobKeeper and JobSeeker programs.

In the GFC, Treasury's memorable advice was "go early, go hard, go households." It worked to prop up demand sufficiently that Australia escaped a recession (alone among G20 economies). Ten years of demonising that response has left the Coalition Government in a tricky political position. Nonetheless, they swallowed their pride to include a one-off cash splash for pensioners and welfare recipients. The money will be quickly spent.

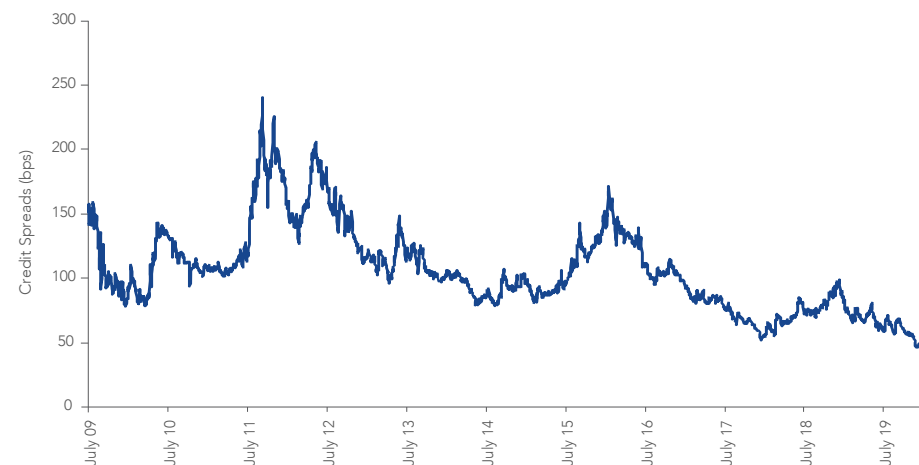
The economic response to the packages is a bit harder to read. Investment incentives are unlikely to be utilised in the near term because uncertainty and falling consumer demand will dominate investment business cases until the outlook clears.

Cash boosts to heavily affected regions and industries are more about preserving businesses from collapse rather than promoting growth. The jury is out on how successful this will be. But it certainly can't hurt; and while chunks of the economy are virtually in lockdown there's little other help available.

Likewise, wage subsidies for apprentices and PAYG relief are both wait-and-see. With the labour market still fairly slack (and likely to deteriorate), business may still let workers go and concentrate instead on shoring up the bottom line and balance sheets. Though the JobKeeper and JobSeeker package which targets this very problem will go a long way to prevent that.

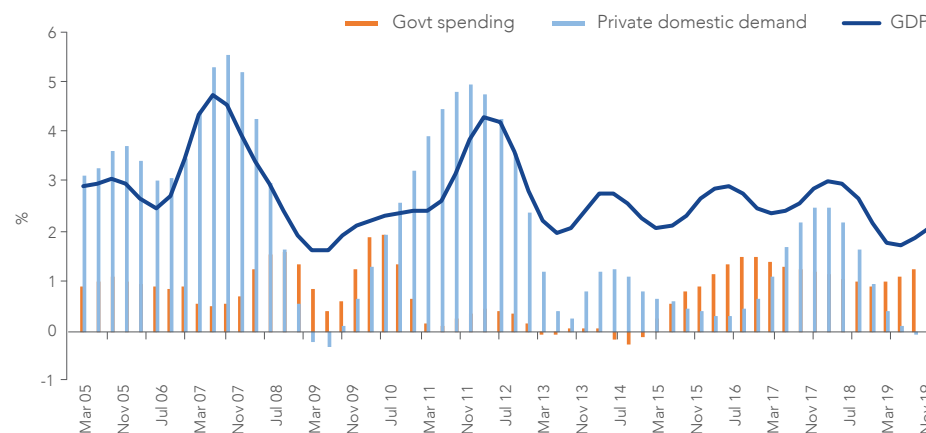
Oil price declines will be a positive for real household incomes, though less positive for natural gas and coal markets. Australia is now in a recession. If COVID-19 is brought under control quickly and companies and jobs make it through without too much damage it may be shallow. Any serious damage to corporate solvency or employment will see a deeper and longer downturn, accompanied by a housing downturn and loan performance problems. The Government will do all it can to avoid this scenario.

Chart 19: Spreads in corporate bonds have continued to widen despite RBA easing
Australian iTraxx past ten years



Source: Bloomberg to 23 February 2020.

Chart 20: Asking for more
Government spending to skyrocket



Source: ABS, RBA.

Range of VanEck Vectors Exchange Traded Funds on ASX

Name	ASX code	Index	Management costs (% p.a.)
Australian Broad Based			
Australian Equal Weight ETF	MVW	MVIS Australia Equal Weight Index	0.35%
Australian Sector			
Australian Banks ETF	MVB	MVIS Australia Banks Index	0.28%
Australian Property ETF	MVA	MVIS Australia A-REITs Index	0.35%
Australian Resources ETF	MVR	MVIS Australia Resources Index	0.35%
Australian Small and Mid Companies			
Small Companies Masters ETF	MVS	MVIS Small-Cap Dividend Payers Index	0.49%
S&P/ASX MidCap ETF	MVE	S&P/ASX MidCap 50 Index	0.45%
Sustainable Investing			
MSCI International Sustainable Equity ETF	ESGI	MSCI World ex Australia ex Fossil Fuel Select SRI and Low Carbon Capped Index	0.55%
MSCI Australian Sustainable Equity ETF	GRNV	MSCI Australia IMI Select SRI Screened Index	0.35%
International			
ChinaAMC CSI 300 ETF	CETF	CSI 300 Index	0.60%
China New Economy ETF	CNEW	CSI MarketGrader China New Economy Index	0.95%
MSCI Multifactor Emerging Markets Equity ETF	EMKT	MSCI Emerging Markets Diversified Multiple-Factor Index (AUD)	0.69%
Morningstar Wide Moat ETF	MOAT	Morningstar Wide Moat Focus Index™	0.49%
MSCI World ex Australia Quality ETF	QUAL	MSCI World ex Australia Quality Index	0.40%
MSCI World ex Australia Quality (Hedged) ETF	QHAL	MSCI World ex Australia Quality 100% Hedged to AUD Index	0.43%
Global Sector			
FTSE Global Infrastructure (Hedged) ETF	IFRA	FTSE Developed Core Infrastructure 50/50 Hedged into AUD Index	0.52%
FTSE International Property (Hedged) ETF	REIT	FTSE EPRA Nareit Developed ex Australia Rental Index AUD Hedged	0.43%
Gold Miners ETF	GDX	NYSE Arca Gold Miners Index	0.53%
Australian Fixed Income			
Australian Corporate Bond Plus ETF	PLUS	Markit iBoxx AUD Corporates Yield Plus Index	0.32%
Australian Floating Rate ETF	FLOT	Bloomberg AusBond Credit FRN 0+Yr Index	0.22%
Australian Subordinated Debt ETF	SUBD	iBoxx AUD Investment Grade Subordinated Debt Index	0.29%
Global Income		Performance Benchmark	
VanEck Emerging Income Opportunities Active ETF (Managed Fund)	EBND	50% J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and 50% J.P. Morgan Government Bond-Emerging Market Index Global Diversified	0.95%

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