3 KEY QUESTIONS FOR EM INVESTORS

PART II: HOW TO NAVIGATE GEOPOLITICAL UNCERTAINTY?

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GlobalEvolution

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In a series of three reports, we identify key questions for 2025 and beyond. In the wake of rising trade tensions, our second piece sheds light on the prospects of EM debt (EMD) in an era of geopolitical uncertainty. Year-to-date, EMD returns have shown resilience, despite rising geopolitical risks. What's required for this pattern to hold and how should investors position within EMD amid lingering policy uncertainty?

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Geopolitical regime shift

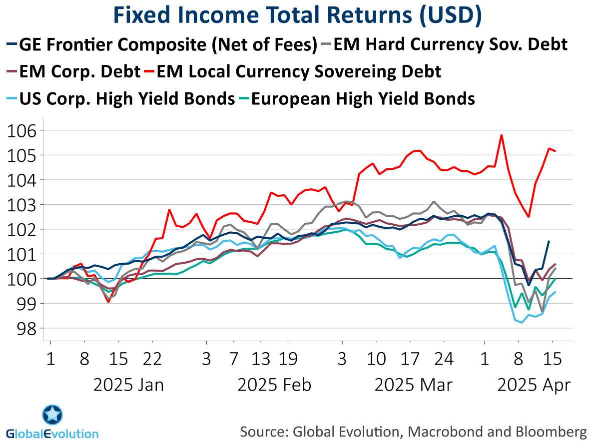
The only certainty is uncertainty – in times of spiraling geopolitical risks, the old adage is more true than ever. Year-to-date, measures of policy uncertainty have leaped higher, culminating with the tariff barrage announced by the White House on April 2nd. Especially in a global trade context, the world economy has entered the most disruptive phase in recent history as the US no longer serves as an anchor for a rule-based global trading system.

In our previous piece, we highlighted some of the economic consequences of rising geopolitical uncertainty, namely peak US exceptionalism (see here). This report sheds some light on the role of EM debt (EMD) as such in a world of lingering geopolitical uncertainty. The overarching question is how investors should navigate through a market environment shaped by geopolitically induced volatility.

Relative resilient EMD – fluke or feature?

Let's take stock of recent market developments first. Year-to-date, Emerging Market bonds have not been unscathed by rising geopolitical uncertainty, but total returns are still mostly positive. Contrary to what many observers might have expected, the asset class has held up better than riskier DM bond peers such as US high yield (see chart 1). The best-performing segments are those often perceived as representing the riskier part of the EMD spectrum. For instance, local currency EM sovereign bonds have outperformed within EMD year-to-date, defying negative consensus expectations at the beginning of the year[1].

Chart 1



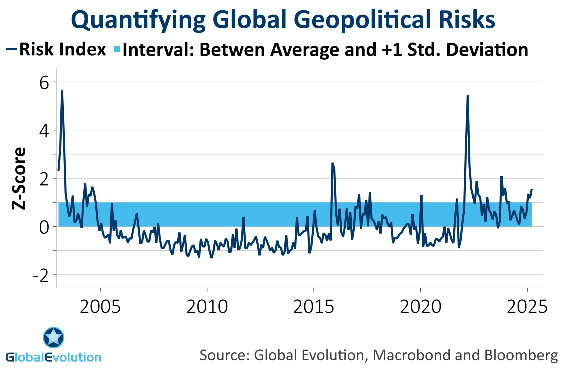
Source: Global Evolution, Macrobond and Bloomberg

Is the resilience of EM debt a fluke or could it continue? The answer to this question is highly dependent on what geopolitical regime lies ahead. For some time, our core thesis has been that geopolitical uncertainty will remain elevated, but not become unanchored.

1 For overview of indices and composite performance please refer to table 1 in the back of this document.

In order to be proven right, geopolitical uncertainty should mean revert to levels above average but below current highs[2], (blue range in chart 2 below).

Chart 2

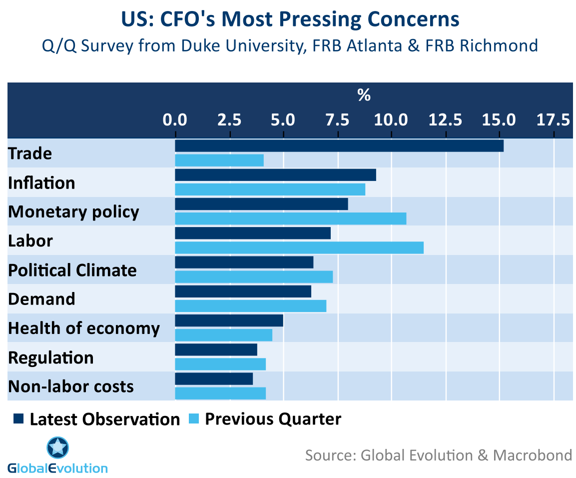


Base case: Peak uncertainty…

At the current juncture, such mean reversion might seem like a brave prophecy. The US tariff blitz announced on April 2nd – the so-called "liberation day" - questions any hopes of such a mean reversion to high, but not too high levels of policy uncertainty. What makes us confident that uncertainty is close to a peak rather than getting un-anchored?

First and foremost, we find it hard to believe that Washington is willing to accept the economic pain that follows from an effective tariff rate staying around 25%. A recession would be all but certain under such a tariff burden. Already before the so-called reciprocal tariffs announced on April 2nd, trade has been catapulted to the top of the list over the most pressing concern among US CFOs (see chart 3 below).

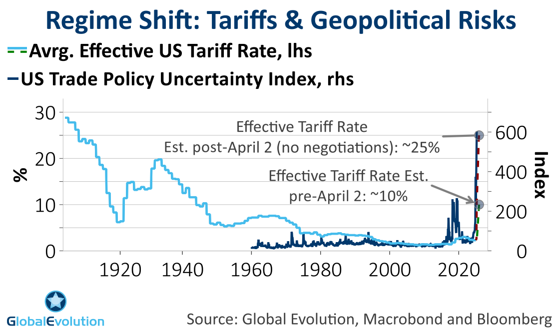
Chart 3



Plunging consumer confidence surveys send the same message: Any euphoria or animal spirit on the back of Trump's election victory has evaporated, with concerns around trade and tariffs being the primary driver. Granted, real economic data has held up well so far. But the longer policy uncertainty lasts, the more likely it becomes that weak confidence will pull the real economy down, as well. The 90-day moratorium on most of the reciprocal tariffs announced only 1 week after "liberation day" reveals a lot about the White House reaction function. The US administration is seemingly unwilling to accept a recessionary outcome and might already have "blinked". Consequently, a policy put is in play, limiting the potential fall-out from trade policy.

Secondly, tariffs should primarily serve as a negotiation tool. While the White House emphasized the revenue-raising feature of tariffs, it has also repeatedly hinted at a path towards trade negotiations. In the same vein, US Treasury Secretary Bessent described the initial tariff announced on April 2 as a ceiling, with the floor still to be determined. Our best guess is that the recession threshold of the effective tariff rate in the US is not too far from 20%[3]. This is meaningfully below the 25% rate implied by the announcements on April 2 (see chart 4). Based on what learned about Washington's reaction function so far, the base case is that the US effective tariff rate end up below 20% and the US skirts a recession.

Chart 4



However, using tariffs as a negotiation tool implies that uncertainty will linger – it's part of the plan in order to maintain a credible threat of additional tariffs. The White House will therefore not offer a clear path to tariff negotiations. Rather, uncertainty is seen as providing leverage in the upcoming tariff negotiation.

[2] For the sake of simplicity, transparency and consistency, we rely on the type of news-based policy uncertainty indices developed by Baker, Bloom and Davis, see here for more details.

[3] Based on a range of model estimates of the impact of tariffs on GDP, we assume a hit to annual US GDP growth ranging between 0.1-0.14 %-pt. per 1 %-pt. increase in the US effective tariff rate.

Third, the Trump administration apparently seeks to frontload the disruptive part of its policy agenda, namely public sector job cuts and tariffs, in order to avoid too much of an overlap with the mid-term elections in 2026. At the end of the day, tariffs remain at odds with Trump's primary mandate from voters, which is to bring down inflation, and therefore poses a risk to Republicans performance in the mid-term election. Consequently, the trade rhetoric from the White House is expected to soften as the year progresses. The less disruptive part – deregulation and tax cuts – is subject to lengthy negotiations in congress and at best themes for the second half of 2025 or even beyond.

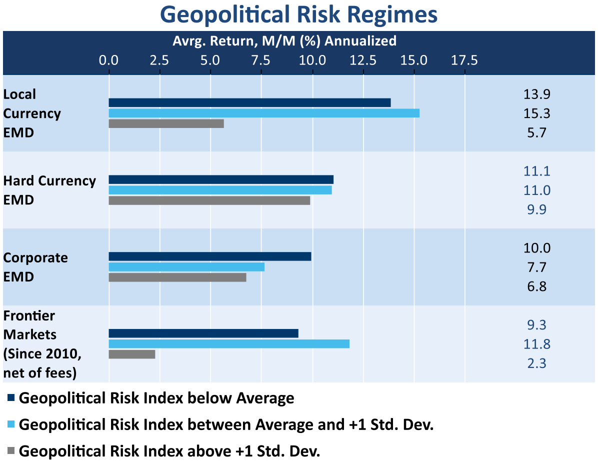
EMD in times of geopolitical turbulence

Current trade tensions are cementing a regime shift towards permanently higher geopolitical uncertainty. But as highlighted above, there are good reasons to believe that geopolitical uncertainty is close to a peak. Ultimately, we expect geopolitical risks to mean-revert to a range above its historical average, but below the current levels, those spikes seen during the first Trump term, the pandemic or Russia's invasion of Ukraine. This amounts to the blue area in Chart 2.

In such a regime, most EMD segments have shown robust returns (see light-blue bars in diagram 1). What's more, segments often perceived as most risky within the EMD universe, i.e. Frontier Markets and local currency sovereign debt, tend to outperform. Current year-to-date performance confirms this picture, see chart 1.

Diagram 1

Average Monthly Returns in Different Geopolitical Risk Regimes



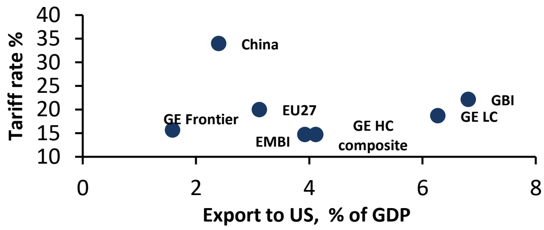
Source: Global Evolution, Bloomberg and Macrobond

Please note: As a proxy for EM HC, LC and HC Corp debt performance above, the three major EMD indices JPM EMBIGD, JPM GBIEMGD and JPM CEMBIBD is used. Global Evolutions Frontier blended currency debt composite is used as a proxy for the above frontier markets performance. All performance shown above is net of fees. For definition and historic returns of the above referenced indices and composite please refer to table 1 in the back of this document. **Past performance** is not indicative of future results which may differ materially from past performance

The outperformance of Frontier Market debt follows intuitively from the fact that these countries tend to be less correlated with global risk factors. As compared to other EMD segments, they are predominantly driven by idiosyncratic factors. Due to Frontier market's limited penetration of foreign bond holders, particularly the local currency share exhibits lower drawdown risks during times of market stress. In the context of trade uncertainty and tariff risks, it is also worth highlighting that Frontier Markets in aggregate are confronted with a similar US tariff rate as their EMD hard currency peers and a lower tariff rate than local currency EMD countries (see chart 5 below). In addition, Frontier countries have a relatively lower export exposure to the US economy when measured as a % of their GDP. All these factors help to explain the outperformance of EM Frontier Debt in times of high, but not too high geopolitical risks.

Chart 5

Reciprocal Tariffs & Exports to the US

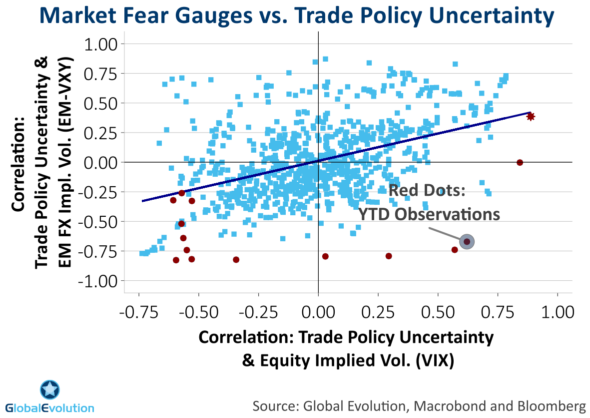


Source: Global Evolution & Census Bureau

EM FX: Unprecedented de-correlation

Maybe more surprising is the outperformance of local currency EMD during times of elevated geopolitical risks. A highly unusual correlation pattern between market risk aversion and EM FX goes a long way in explaining the year-to-date outperformance of local currency EM debt. As chart 6 highlights, the usual pattern is that EM FX implied volatility (a fear gauge for FX markets) is positively correlated with trade policy uncertainty. The same goes for equity market implied volatility (VIX). In 2025, however, correlation patterns changed. This year, EM FX has largely shrugged off rising trade policy uncertainty (negative correlation), while equity market risk aversion has risen in tandem with stiffening tariff headwinds (positive correlation). We believe there are cyclical and structural drivers behind such de-correlation. On the cyclical side, fading US exceptionalism has prevented the US Dollar from appreciating despite the latest risk-off mood. This has helped EM FX risk aversion to decouple from geopolitical risks. Structurally, policy uncertainty emanating from the White House might have undermined the "exorbitant privilege" of the US Dollar being the global reserve currency – at least at the margin.

Chart 6



Source: Global Evolution, Macrobond and Bloomberg

The allure of Frontier and local currency debt

In sum, the surprising resilience of EM debt is not a fluke but can be explained by structural as well as cyclical factors. Provided geopolitical uncertainty and trade policy uncertainty, in particular, are in the process of peaking, we believe this robust performance pattern will continue – despite lingering geopolitical uncertainty. As the above analysis shows, Frontier Market debt and local currency sovereign debt look particularly well positioned for such an environment. Clearly, peak geopolitical uncertainty does not mean EM debt is immune to headwinds from tariffs - even if these are being lowered over the coming months, as we currently expect. In order to mitigate tariff risks, we are underweight Asian EM countries, as the region screens most vulnerable to higher US tariffs on various measures.

Policy, not data will guide markets

A final word on risk and reward in the wake of our main scenario of peaking geopolitical uncertainty, paving the way for robust EMD returns over the coming months. The April 2 tariffs announcements are still being digested and the situation remains fluid. Additional near-term setbacks are far from ruled out as headline risk is high and the range of outcomes wide. Over the summer, hard data is very likely to weaken as the tariff-induced confidence shock takes its toll. But in a policy-driven growth slowdown or - worst case - recession, markets will take guidance from policy (leading), not data (lagging). This makes the "peak uncertainty" thesis even more decisive.

On the policy front, investors are currently witnessing a game of chicken between the White House, its trading partners and the Fed. Ultimately, one or more players will blink, delivering some kind of policy put. The 90-day break from reciprocal tariffs indicates that we might not be that far from a strike level for such a put, effectively limiting the downside potential in the months to come. At the same time, the set-back following the reciprocal tariff announcements on April 2 have created better entry points from a valuation perspective, particularly in lower- rated segments. EMD investors should therefore not lose sight of the opportunities and return potential, despite of the regime shift towards permanently higher geopolitical uncertainty.

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Table 1: Major EMD Indices and Global Evolution Frontier Blended Debt Composite – Definition and performance

Index	Definition	Indices & Composite Returns				
		2024	2023	2022	2021	2020
Frontier Markets (Composite, gross of fees)	is Global Evolution's own **Frontier Blended Currency Debt Composite**. The composite is incepted dec 15, 2010. Its GIPS compliant and its representative of how Global Evolution is running its frontier blended currency debt strategy.	16.51	11.71	-7.66	11.75	3.32
Frontier Markets (Composite, net of fees)	is Global Evolution's own **Frontier Blended Currency Debt Composite**. The composite is incepted dec 15, 2010. Its GIPS compliant and its representative of how Global Evolution is running its frontier blended currency debt strategy	15.57	10.78	-8.49	9.85	2.24
EMD Hard Currency	is the **J.P. Morgan EMBI Global Diversified Index (EMBI GD)**: The index is a market capitalization-weighted total return index of hard currency (USD, EUR, GBP) denominated Brady bonds, loans, Eurobonds and local market debt instruments traded in emerging markets.	10.58	11.09	-17.78	-1.8	5.26
EMD Local Currency	GBIEMGD is **the J.P. Morgan Government Bond Index for Emerging Markets Global Diversified (GBIEMGD)**. The index is a comprehensive global local emerging market index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure.	1.19	12.70	-11.69	-8.75	2.69
Corporate EMD	is the **J.P. Morgan Corporate Emerging Market Bond Index Broad Diversified**, which track USD denominateddebt issued by emerging market corporations. CEMBI BD is a granular asset class with 1,331 bonds of 609different issuers from 52 different countries	13.75	9.08	-12.26	0.91	7.13