

EM DEBT RESILIENCE IN UNCERTAIN TIMES: FLUKE OR FEATURE?

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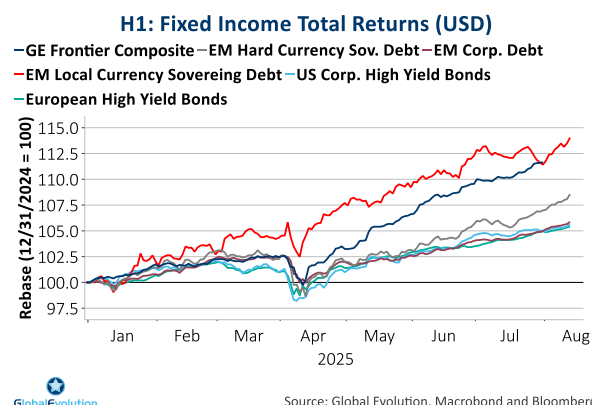
In a market environment where uncertainties abound, EMD has shown remarkable resilience year-to-date. In our view, higher uncertainty and strong EMD performance do not contradict each other. The DM-centric nature of the structural drivers behind a more uncertain investment environment implies that EMD has outperformed because of a more uncertain investment environment – not despite of it, forcing many investors to rethink the market narrative.

By Witold Bahrke, Senior Macro and Allocation Strategist

Why has the consensus proven wrong?

Investors find themselves in a world where uncertainties abound. Nevertheless, Emerging Market bonds have shown remarkable resilience year-to-date, proving the consensus at the beginning of the year spectacularly wrong. Neither elevated trade policy uncertainty nor mounting geopolitical risks have done much harm to emerging market debt (EMD). Not only are returns comfortably in positive territory. The asset class also managed to outperform its DM peers such as US High Yield bonds (see Chart 1). EM sovereign bonds issued in local currencies are topping the list with double digit returns in the first half of the year (please refer to table 1 for clarification of indices).

Chart 1



For investors, this begs the question whether this is a one off. We don't think it's a lucky punch, but more deeply rooted as the structural drivers behind a more uncertain investment landscape originate in the

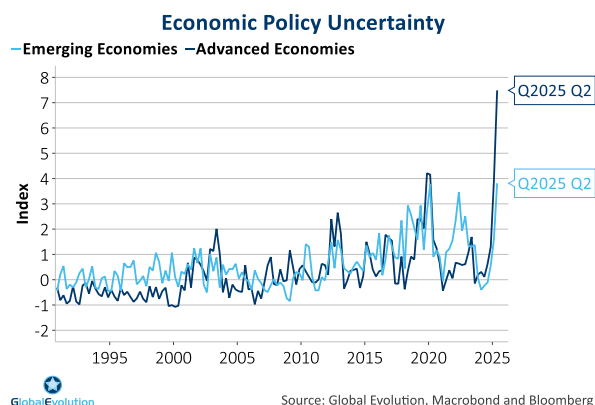
developed world, not in EM. This is not to say the EM assets are immune to rising uncertainties of various kinds, but they do not stand first in line when it comes to the negative spillovers and might even be able to benefit from higher uncertainty. In our view, the correct narrative therefore is that EMD has outperformed *because* of a more uncertain investment environment – not *despite* of it. So what are the primary structural drivers behind rising uncertainty? We believe it mainly comes down to three regime shifts, the world economy is currently undergoing.

Three regime shifts

First, investors grapple with a structural shift towards higher policy uncertainty and geopolitical risks. Uncertainty is rarely positive for risk appetite, neither in EM nor DM. However, it's worth keeping in mind that various measures of policy uncertainty have risen much more in developed markets – first and foremost in the US – than in the emerging world¹ (see Chart 2). This goes both for economic policy as such, and trade policy, in particular. While we believe the shift towards higher geopolitical and policy uncertainty marks a regime shift for the global economy overall, it appears to be driven out of developed market, supporting the relative performance of EM bonds.

¹ See e.g. <http://www.policyuncertainty.com>.

Chart 2

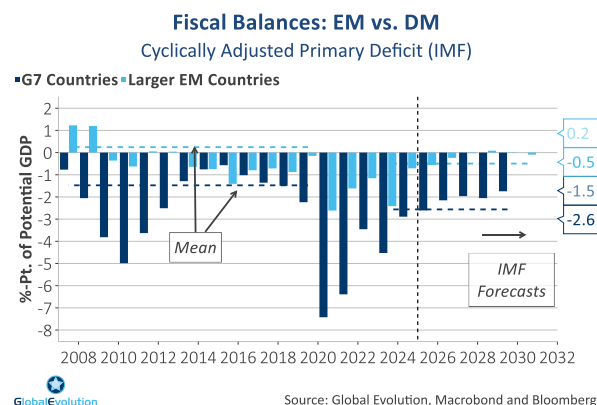


These types of uncertainties are unlikely to return to pre-pandemic levels anytime soon. On a positive note, however, the latest trade policy twist and turns confirm our view that policy uncertainty peaked around “liberation day” in early April, which should buoy overall risk appetite going forward. The mirror image of peak policy uncertainty is a convergence of the effective US tariff rate below recessionary levels (around 20% in our view) over the coming months, supporting the absolute performance of EM debt, as well. In line with our main scenario for Trump’s second term (see [here](#)), the US administration has “blinked” several times in the tariff game of chicken, postponing deadlines and at least partially backtracking from previously announced tariff rates. When push comes to shove, President Trump seems unwilling to accept the recession risks stemming from an effective tariff rate of around 25% as it stood in early April, when uncertainty peaked.

Still, geopolitical risks and policy uncertainty are likely to remain above their historical averages, albeit below the extreme levels seen in March and April. The tariff genie is out of the bottle. Hoping for a return to 2024 tariff levels seems futile. Contrary to what one might expect, our analysis shows that such an environment of high, but not extreme policy uncertainty is supportive for EM debt returns, even in absolute terms, see [3 Questions for EM Investors - Part II](#). What might seem counterintuitive, can probably be explained by some kind of central bank easing that tends to follow episodes of heightened policy uncertainty – exactly the type of easing the market is currently expecting with one full percentage point of cuts from the US central bank priced in the coming 12 months.

Secondly, we are currently witnessing a regime shift from fiscal conservatism to fiscal largesse, fueling uncertainty around countries’ debt trajectory and credit worthiness, in and of itself a key driver of global bond markets. As with geopolitical risks and policy uncertainty, this regime shift is mostly a developed markets phenomenon. Budget deficits adjusted for cyclical effects are set to perform worse in DM than in EM over the coming years (see Chart 3). Politicians in emerging markets have learned some of their lessons from previous episodes of fiscal risks spiraling out of control. DM policymakers, on the other hand, show no appetite for fiscal discipline. The current tax package negotiated in the US congress and Germany’s quantum leap towards higher defense and infrastructure spending are testament to this. In the wake of structurally higher DM deficits, investors naturally demand a higher compensation for fiscal risks in the form of higher yields (i.e. a lower price for bonds) – more so in DM than in EM. While this is not the only factor explaining a tightening of the EM-DM yield gap since the onset of the pandemic, it certainly contributed, benefitting the relative performance of EM debt versus DM debt.

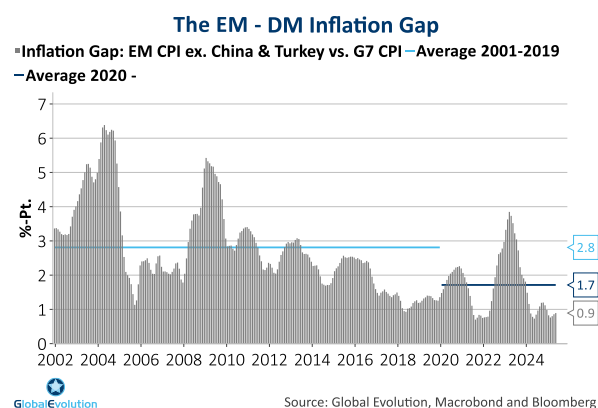
Chart 3



Thirdly, the transition from a low inflation environment to a somewhat higher trend inflation is primarily a DM story, as well. In Developed Markets, geopolitical risks, the changing contours of globalization, newfound fiscal largesse as well as demographics caused an exit from the post-GFC “low-inflation” era. In the Emerging Markets sphere, however, a relatively disciplined monetary and fiscal policy stance and disinflationary forces from China has prevented trend inflation from rising (see [EM Inflation: mind the gap](#)).

Developed economies leaving the low-inflation era behind means the trade-off between growth and inflation is deteriorating. Going forward, accelerating growth will create higher inflation risks as compared to the pre-pandemic years. Consequently, inflation uncertainty is rising. Again, investors need compensation for higher inflation risks, which comes in the shape of higher yields. On the EM side of the equation, there are limited signs of a deteriorating growth-inflation trade-off as inflation today is by-and-large where it was before the pandemic, lending additional support to the relative performance of EM debt. We believe the gap between EM and DM inflation has narrowed not only cyclically, but structurally. Such a regime shift should improve the risk-reward in EM debt relative to DM bonds. Particularly local currency debt stands to benefit as lower inflation means higher real rates, supporting EM currencies.

Chart 4



EMD resilience: Rethinking the narrative

The bottom-line is that some of the most prominent regime shifts causing a more uncertain macro and market environment are a bigger challenge for developed markets than for emerging markets. This is not least a reflection of improving policy credibility as well as macro stability in Emerging Markets over recent years. Current accounts are back in positive territory and external debt levels have declined substantially from 2020-highs. It goes without saying that emerging market debt returns aren't immune to higher policy uncertainty, whether it originates in EM or DM countries. Higher DM yields resulting from elevated inflation and fiscal uncertainty will not go unnoticed in EM, either, as these yields are key drivers of global monetary conditions. However, the key point here is that emerging markets are not first in line to be challenged by these factors and might even benefit from them. In the same vein, higher uncertainty and strong EMD performance do not contradict each other, forcing many investors to rethink the market narrative. The DM-centric nature of the structural drivers behind a more uncertain investment environment implies that the resilience of EM debt is a feature, not a fluke.

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, net of fees)	is Global Evolution's own Frontier Blended Currency Debt Composite . The composite is inceptioned 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
EM Hard Currency Sovereign Debt	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 Sovereign Debt	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
EM Corporate Debt	is the J.P. Morgan Corporate Emerging Market Bond Index Broad Diversified , which track USD denominated debt issued by emerging market corporations. CEMBI BD is a granular asset class with 1,331 bonds of 609 different issuers from 52 different countries	13.75	9.08	-12.26	0.91	7.13
US Corp High Yield Bonds	Is the Bloomberg US Corporate High Yield Total Return Index Value Unhedged USD . The index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Bloomberg EM country definition, are excluded.	8.19	13.45	-11.19	5.28	7.11
European High Yield Bonds	Is the Bloomberg Pan-European High Yield Index . The index measures the market of non-investment grade, fixed-rate corporate bonds denominated in the following currencies: euro, pounds sterling, Danish krone, Norwegian krone, Swedish krona, and Swiss franc. Inclusion is based on the currency of issue, and not the domicile of the issuer. (Future Ticker: H02500US).	10.11	14.69	-8.49	4.36	3.97

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