EMERGING MARKETS DEBT MIDYEAR UPDATE: SURPRISE, SURPRISE, SURPRISE

By Peter Marber

For many of Wall Street, the first six months of 2025 has felt like a lifetime.

Many investors planning for a simple pro-business orientation for Donald Trump's second administration have been forced to digest *dozens* of surprises - both economic and geopolitical - including higher-than-expected tariffs, the U.S. bombing of Iran, attempts to oust the independent Fed president, changing stances on the Russian/Ukraine invasion, among several others.

With that said, the markets have tried to shake off the headlines with a wait-and-see attitude rooted in "TACO" – a belief that Trump Always Chickens Out when coming to final actions.

Amid the noise, Emerging Markets Debt has proven resilient with all key benchmarks posting impressive returns through the first half. In hard currency, JP Morgan's Emerging Markets sovereign benchmark (EMBI GD) surged by **+5.91%,** while the diversified corporate index (CEMBI GD) rose **+4.04**%, well ahead of the Bloomberg U.S. Aggregate which advanced around 2%. Sovereign spreads narrowed by **10 bps** to close at **+314 bps** above Treasuries (mostly in the high yield space), while corporate spreads widened by **2 bps** to end at T **+208 bps.**

But the telling story is the roller-coaster chart below, highlighting the initial fear over the tariffs pushing-up EMD credit spreads 80+ bps. after "Liberation Day" in early April only to fall to a record low for 2025 by July with local EM currency yields dropping around 40 bps. to a 52-week low.

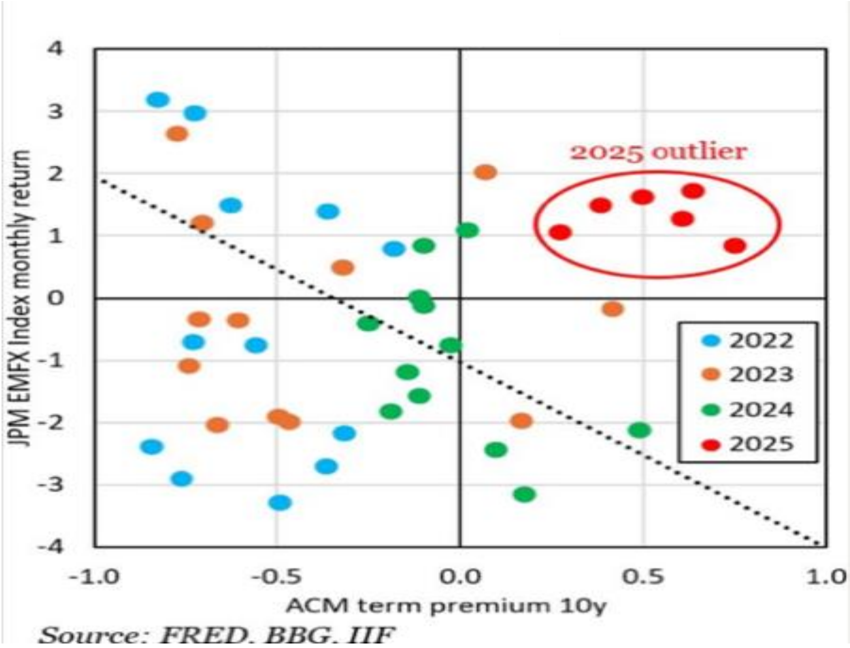
Fig. 1 EMD Hard Currency Spreads and Local Currency Yields

Source: JP Morgan

The U.S. Dollar's Decline

The bigger surprise has been the broad weakening of the U.S. dollar, which has propelled the EM local currency index **+12.73%** through June. One fascinating chart that may catch investors' eyes comes from the Institute for International Finance ("IFF") regarding EM FX regimes and the U.S. dollar.

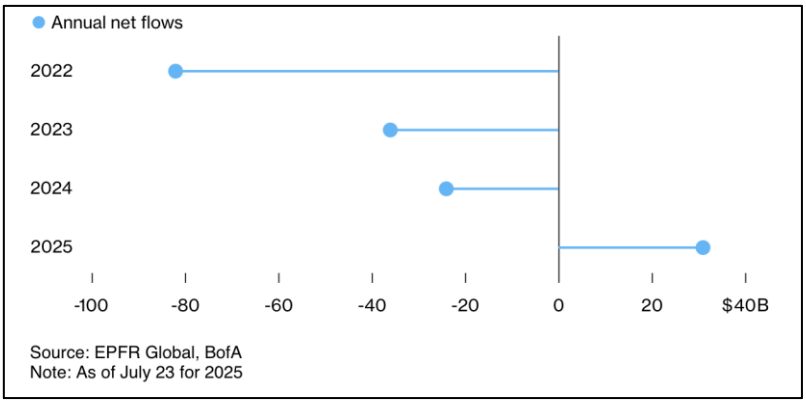
Fig. 2 EMFX Decoupling from U.S. Interest Rates in 2025



The above chart plots EMFX returns vs. U.S. term premia, something that suggests a significant investor regime shift. In 2025, Emerging Market currencies have been rallying in the face of rising U.S. yields. Compared to history, that shouldn't happen. For the last two decades, what we've seen is the higher U.S. yields, the weaker EMFX returns – and vice versa.

Amid the tariff turmoil, firm U.S. rates, and general uncertainties, the U.S. dollar should be rallying - but it isn't. Perhaps Emerging Market countries are no longer passive price takers of the global U.S. dollar cycle. With stronger institutions, better macro frameworks, and reduced FX mismatches, we believe investors may be recognizing the significant policy improvements in Emerging Markets over the years.
As the IFF note mentioned, over time this regime shift may lead to EMD being less of a macro call and more about picking winning and losing assets in a Trump-led America. Some countries may find it easier to negotiate more favorable Trump's tariffs, and many are not that impacted by them at all. And investors seem to be taking notice, as evidenced by positive net flows into EMD after three years of net withdrawals which fueling the regime shift:

Fig. 3. Emerging Market Debt Attracting Investors in 2025



With over 75 countries represented in EM bond indices, many markets remain under the radar of global turbulence. For EMD investors, they present a trending opportunity with healthy carry and credit spreads. Strengthening currencies also help ease financial conditions, fueling further growth. With some signs that U.S. growth is slowing, there may also be some tailwinds with eventual Fed rate cuts sometime in the second half of 2025 which we believe could propel EMD returns even further.

Disclaimer and Definitions

Index	Definition
J.P. Morgan CEMBI Broad Diversified	is a market capitalization weighted index consisting of US dollar denominated emerging market corporate bonds.
J.P. Morgan EMBI Global Diversified	is the J.P. Morgan EMBI Global Diversified Index (EMBI GD): The index is a market capitalization-weighted total return index of U.S. dollar and other currency denominated Brady bonds, loans, Eurobonds and local market debt instruments traded in emerging markets.
J.P. Morgan GBI-EM Global Diversified	is the J.P. Morgan Government Bond Index for Emerging Markets Global Diversified (J.P. Morgan GBI EM GD) : The index is a comprehensive global local emerging markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure.
Bloomberg U.S. Aggregate Index	is a broad-based benchmark that tracks the performance of the investment-grade fixed-rate taxable bond market in the U.S.

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