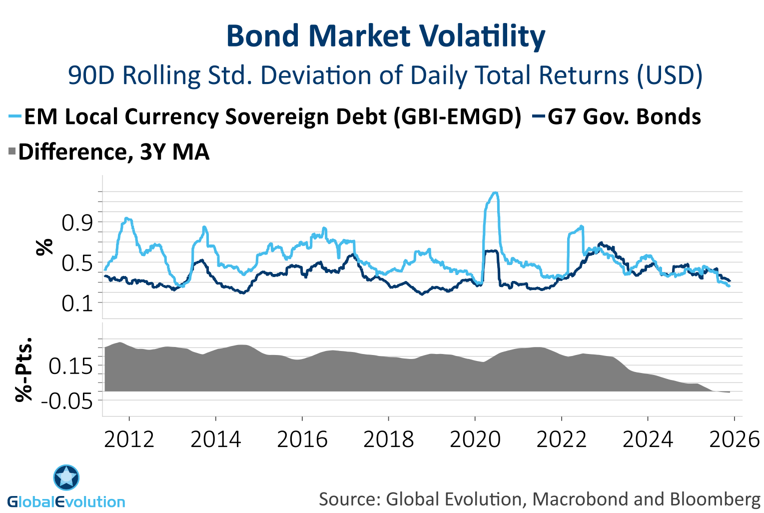
2026 AND BEYOND: EMD INVESTMENT THEMES FOR A NEW MACRO REGIME

EM debt (EMD) has been among the best-performing asset classes year-to-date, beating developed market (DM) peers such as US high yield. A powerful mix of declining trade policy uncertainty, fiscal expansion, monetary policy, as well the AI investment boom creates a **fertile ground for EMD returns as we head into 2026**. Notwithstanding lingering growth concerns, the global business cycle is in a better place than meets the eye. Rather than extrapolating recent US labour market weakness into a recessionary spiral, job growth might be as weak as it gets as the economy exits a mid-cycle soft patch (check out our latest outlook here). At the same time, China is expected to revamp its fiscal stimulus efforts in 2026. Over in the Euro Area, the fiscal expansion in Germany is beginning to fuel growth positively next year.

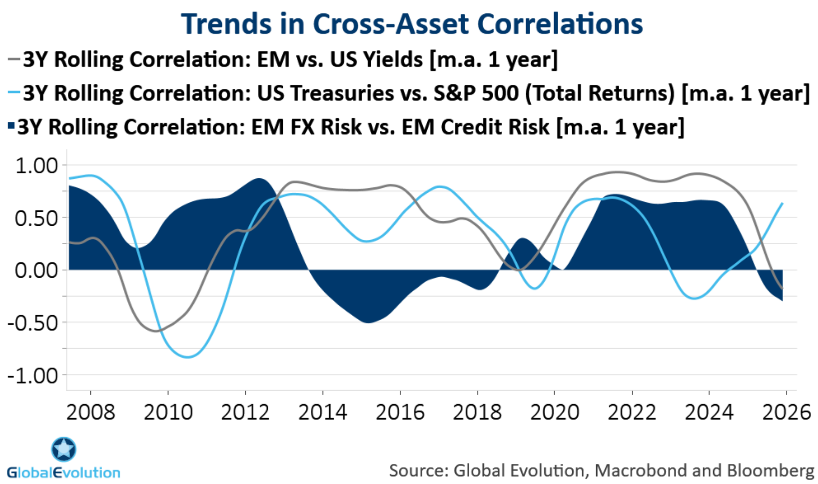
To be sure, uncertainty remains elevated as the world is undergoing several structural shifts: Inflation, geopolitical risks and fiscal leverage have experienced level shifts higher in the developed market sphere and are set to change the global macro landscape profoundly. However, as these regime shifts are driven out of DM, the EM universe does not stand first in line when it comes to the negative ramifications (for details, see here). Somewhat counterintuitive to many, the upshot is that the risk-reward in EM debt relative to DM debt has improved as, *because* of higher uncertainty – not *despite* of it. Currencies should be among the main beneficiaries of EM's outperformance within fields of inflation, geopolitics and fiscal policy. From a medium-to long-term asset allocation perspective, **local currency EM sovereign debt** therefore is our favourite way to express such improving risk-reward in EMD relative to DM bonds, as bond market volatility has increased in DM, not so much in EM (chart 1).

Chart 1: Volatility mark-up between EM and DM bonds has evaporated.



An important aspect of these regime shifts is that market cycles are becoming shorter[1]. Firstly, the flip side of frequent spikes in geopolitical risks is an increase in market drawdown risks. Secondly, higher trend inflation in DM has removed central bank's structural easing biases, constraining their ability to smooth macro and market fluctuations. Shorter market cycles and bouts of volatility highlight the importance of an active asset allocation approach within EMD. In **blended EMD strategies**, such an approach enables investors to harness the return potential resulting from declining correlations between the main EM risk premiums. At the same time, it creates new diversification opportunities (chart 2) as the classic DM bond-equity portfolio split fails to deliver on that front.

Chart 2: Declining correlations between EM and DM as well as intra-EMD.



The flip-side of a strong year-to-date run in EMD that took most investors by surprise is that valuations look less attractive than 12 months ago. EM sovereign spreads are tight and market sentiment is vulnerable, spurring volatility in the short-term. Within hard currency EM debt, **carry should therefore be in the driver's seat** when it comes to overall returns. On the other hand, we expect relatively little return contribution from spread compression. Optimizing the trade-off between carry and credit risk implies a preference for issuers that are candidates to become 'rising stars' i.e. higher-rated countries within the high yield segment en route for an upgrade to investment grade, such as Paraguay, Serbia and Morocco. Also, quasi-sovereign bonds can offer attractive carry, while limiting credit risk in the portfolio.

[1] We define a market cycle as the time span between 10% drawdowns following new all-time highs in global equities.

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Appendix 1 – Relevant Indices – Definition and Performance

Index	Definition	Index Returns					
		2025 YTD.	2024	2023	2022	2021	2020
J.P. Morgan GBI-EM GD	is the **J.P. Morgan Government Bond Index for Emerging Markets Global Diversified (J.P. Morgan GBI EM GD), in the text also referred to as "local currency EM sovereign debt"**: The index is 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. "EM FX Risk" mentioned in chart 2 refers to the FX component of GBI EM GD total returns.	17.40	-2.38	12.70	-11.69	-8.75	2.69
J.P. Morgan EMBI GD	is the **J.P. Morgan EMBI Global Diversified Index (EMBI GD), in the text also referred to as "hard currency EM debt":** 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. EM sovereign spreads mentioned in the text refer to the credit spreads of EMBI GD. "EM Credit Risk" mentioned in chart 2 refers to the credit component of EMBI GD total returns.	13.35	6.54	11.09	-17.78	-1.80	5.26
S&P 500	is the 500 widely held stocks in US equity market. The index is market capitalization-weighted and includes stocks of industrial, financial, utility, and transportation companies.	17.18	23.31	24.23	-19.44	26.89	16.26
US High Yield	is the **Bloomberg US Corporate High Yield Bond Index**, measuring the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield I the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.	7.79	8.19	13.45	-11.19	5.28	7.11
G7 Government Bonds	Bloomberg Global G7 (DM Gov Debt) Total Return Index Value Unhedged USD measures investment grade debt from G7 countries (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States).	5.84	-4.67	2.92	-18.06	-6.97	8.86
US Treasuries	is the Bloomberg US Treasury: 7-10 Year Index, measuring USD-denominated, fixed-rate, nominal debt issued by the US Treasury with 7-9.999 years to maturity.	9.22	-0.70	3.58	-14.89	-3.07	9.98