

Emerging markets fixed income Past, present and future

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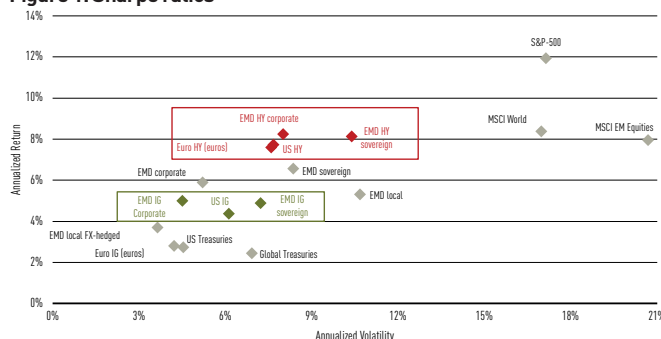
Past

Over the last decade, emerging market (EM) sovereign and corporate hard-currency debt outstanding has grown significantly, with just over half of it rated investment grade. Over the same time period, EM local currency debt for sovereigns and corporates has grown to become the dominant segment of EM debt.

Through this period, emerging market economies, including frontier countries, have on average grown by more than 4% and companies domiciled in these countries have generally benefited as well. This growth has been achieved without a significant increase in government debt. According to IMF data, net government debt for advanced economies is above 80% while for emerging economies it hovers close to 45%.

When looking at historical returns generated from underlying investments, it is helpful to look at the Sharpe ratio, which expresses how much excess return is received for the volatility of holding a riskier asset. Using data from 2003-2024, the return profile for hard currency emerging market debt issued by sovereigns and corporates is significantly above that of sovereign debt issued by the US, other developed market sovereigns and US investment grade companies, even during a period that includes US exceptionalism.

Figure 1: Sharpe ratios



Source: Bloomberg data from 2003-2024. Index tickers – US IG: LUATRUU index, US HY: LF98TRUU index, euro IG: LP06TREU index, euro HY: LP01TREU index, EMD sovereign: JPEIDIVR index, EMD corporates: JBCDCOMP index, EMD local: JGENVUUG Index, US Treasuries: LUATRUU Index, DM sovereigns ex-US: LGTRTRUU Index, all indexes are in USD except for euro IG and euro HY

Present

The wave of defaults due to the pandemic and the Russian invasion of Ukraine is behind us: there have been no sovereign defaults since the end of 2023. We believe default rates have peaked for EM sovereigns which should be a tailwind for performance. EM corporate defaults have also been decreasing over the last couple of years. The outlook from credit rating agencies for emerging-market debt has become more positive than negative: ratings upgrades are on an improving trajectory, with more upgrades than downgrades recently. In EM sovereign markets there have even been a few 'rising stars' – credits that are expected to receive at least two out of three investment grade ratings.

EM hard currency debt has outperformed similarly rated US corporate debt year-to-date in 2025, including during and after the tariff

announcements. EM currencies have held up well vs. the dollar, which may provide EM central banks with leeway to cut rates aggressively to manage potentially lower growth.

EM sovereign and corporate debt indexes, unlike equity indexes, are constrained at the country level. As of end-June 2025, Saudi Arabia and Mexico have the largest weights in the J.P. Morgan EMBI Global Diversified index at around 5% each. This relatively low country concentration risk contrasts with global equity portfolios, which have massive exposure to US stocks, and global emerging markets equity portfolios tracking the MSCI Emerging Markets Index, which have over 80% exposure to stocks in China, Taiwan, India, South Korea and Brazil.

Future

We believe relative valuations vs. other fixed income sectors are attractive in EM IG and EM HY and that has driven strong crossover interest in the sector, which we expect to continue. Yields are in the top quartile of a fifteen-year trading range.

If the dollar stabilizes, or weakens, and if policy rates decline globally, as expected, it may provide EM debt with important tailwinds over the coming years. In addition positive tail risks may emerge over the coming year. Easing of tariffs, reduced geopolitical tensions or negotiation of ceasefires as well as continued stabilization of growth in China would be positive for EM assets. In such an environment, we believe EM sovereign and corporate dollar denominated debt is likely to continue to perform well. Local currency debt may also perform well over the long term though there could potentially be periods of dollar strength that could generate volatility.

According to IMF forecasts, growth in emerging markets is still expected to be stable around the 4% mark, despite a projected slowdown in US growth. Growth in China, at over 5% in first-half 2025, has been pretty strong despite the trade war, but even during last couple of years of slower growth in China, commodity prices have been trading in a higher range and are likely to remain so over the coming years due to supply constraints and demand from decarbonization; this should benefit EM countries which are largely commodity exporters: more than 60% of the countries in the EM sovereign hard currency index are commodity exporters.

Policy uncertainty in the US has led to an increase in flows into EM funds over the last several months which we think will be an important technical driving performance. EM external debt net issuance for sovereigns and corporates combined is expected to be negative, which could create additional upward pressure on existing bond prices. Investors are still underweight the asset class and we are seeing renewed interest in the sector from institutional investors globally. These positive technical factors may provide an additional tailwind to returns.

In uncertain times, we believe actively managed investment strategies can provide advantages over passive investments in navigating liquidity, policy shifts and geopolitical risk, especially in frontier countries like Argentina, Egypt and Nigeria which account for over 26% of the J.P. Morgan EM sovereign debt index. An active investment manager can focus on forward looking stress testing and actively seeking opportunities provided by events and market volatility while also managing for downside risks. A deep bench of seasoned portfolio managers and on-the-ground research analysts is vital to developing a nuanced view of the complex emerging markets debt opportunity set.

