

Changing tides: how emerging market debt is adapting to a sea of change



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Emerging markets (EM) have proven proficient in adapting to an ever-changing geopolitical and macroeconomic landscape and, despite the fears surrounding President Trump's tariffs, have navigated the impact well. The diversification of the EM universe has proven a cushion for fixed income investors.

Supported by generally lower debt levels, both in sovereigns and corporates, continued strong growth and less dependency on the dollar and the US economic cycle, EM debt (EMD) has emerged as an attractive space for fixed income investors.

Turning the tariff table

Coming into 2025, the narrative was dominated by concerns over the impact of freshly inaugurated President Donald Trump's tariff policy, with markets fearing it would dent EM trade and growth prospects. However, half a year since these policies were implemented on 1 April, so-called 'Liberation Day', EMs have demonstrated resilience. In fact, it is the US that appears to face the most notable growth risks and downward revisions, with the IMF's April prediction for US growth in 2025 receiving a -0.9% downgrade since its January prediction, while EM growth was downgraded to a lesser extent, by -0.5%¹.

Global trade is facing disruption, however, the impact will vary significantly across regions and countries. For example, Brazil, despite facing a high tariff rate of 50%, is relatively insulated due to its low export-to-GDP ratio and domestically focused economy, whereas Vietnam, with a lower 20% tariff following a trade deal with the US, may be more exposed given its larger trade footprint and deficit with the US. Overall, tariff levels have moderated since Liberation Day and with the baseline level being 10%², this should not materially alter relative competitiveness. In fact, it could be argued that the tariff saga is a much bigger shock to Western allies of the US, whose transition from seeing America as an ally and trading partner to imposing potentially quite damaging tariffs on them has been quite abrupt.

Growth levels could also experience a boost in the post-tariff paradigm, where manufacturers move to near-shoring or friend-shoring, or buoyed instead by domestic markets or intra-regional trade. Furthermore, the breadth of the accessible EM universe,

encompassing nearly 100 countries, ensures that despite country-specific growth risks as a result of tariffs, there is plenty of room for diversification.

As we saw during the US-China trade war in 2018, companies and economies adapt as supply chains reconfigure, new trade relationships emerge, and domestic markets strengthen. Although markets initially reacted sharply to the Liberation Day announcement, the response was short-lived, evidenced by spread movements that have since tightened relative to the start of the year, and are now at lower levels prior to the Liberation Day announcement. This suggests markets are beginning to respond more to tangible developments than to headline noise.

The tariff turmoil adds to questions already being raised about the sustainability of the US exceptionalism narrative that has dominated in recent years. Again, this can stand to benefit EMD as investors rotate out of US centric portfolios and into other portions of the market, particularly in a scenario whereby US yields fall and the relative attractiveness of EM increases.

Painting the macroeconomic picture

From a fundamental perspective, EMs face a legacy of misconceptions. When the EM universe was first launched, many risks were idiosyncratic, individual country risks, while investors were sanguine about those facing developed markets (DMs). Today, we are experiencing a convergence in perceptions of risk, as DMs grapple with challenges from fiscal, growth and productivity perspectives.

DM economies are beginning to be characterised by large fiscal deficits and growing political instability. Meanwhile, EMs profit from low debt-to-GDP ratios, as well as an improved reputation for fiscal discipline. This can be seen in the positive rating migration in 2024, with 14 EM sovereigns receiving upgrades – the most positive year for net upgrades since 2011³.

At a time when investors are growing increasingly concerned about the sustainability of US debt, EM countries benefit from relatively low levels. The average debt-to-GDP ratio of emerging market and middle income economies is 75%, while that of advanced economies is 110%⁴. Stable debt levels create a buffer to absorb global shocks.

The EM growth story also benefits from a more positive demographic impulse. 85% of the world population lives in an EM country⁵, with many EM economies benefitting from ongoing population growth. This creates growth momentum, with a larger working age population, as well as stronger potential for domestic consumption. Meanwhile, DM economies are grappling with the additional strain of a declining workforce and an

increased burden of an ageing population on government debt.

Given the US's growing fiscal deficit, significant policy shifts and converging interest rate differentials, there is a sense that the narrative of US exceptionalism is at least stalling, if not fading. If this trend continues, it could trigger a meaningful rotation out of US-centric portfolios and into emerging markets, as we have seen in the past during previous periods of US weakness. These markets are increasingly attractive, underpinned by improving fundamentals and a growing independence from US policy cycles, thanks in large to the development of credible, autonomous monetary and fiscal frameworks.

Much ado about the dollar

Regarding the US dollar, after an extended period of strength, we believe it now faces structural headwinds. This is a favourable backdrop for emerging markets, particularly for local currency sovereign bonds, which tend to perform well when the dollar weakens. Year-to-date, these bonds have returned approximately 14%, according to Bloomberg data as at the end of August 2025, during a period when the dollar index (DXY) has declined by around 11%. The dollar had its worst first half-year in more than 50 years. This dynamic could help reverse years of EM currency underperformance and create new return opportunities.

Looking ahead, if the Federal Reserve resumes its rate-cutting cycle, we see another tailwind for EM bonds. Historically, local currency sovereign bonds tend to outperform in such environments, benefiting from shifting interest rate differentials and a softer dollar. EM economies themselves also stand to gain from a weaker dollar and lower US rates, as this reduces the cost of servicing dollar-denominated debt and helps countries re-access international debt markets as yields fall. These conditions typically encourage capital inflows, enhance export competitiveness, support commodity prices, and ultimately improve financial stability and growth prospects across EMs.

While a Federal Reserve interest rate cut would be beneficial, EM countries are no longer reliant on the US to lead their own interest rate cycles, marking a significant departure from history. In recent years, EM central banks have demonstrated greater independence and credibility. For example, central banks in EMs acted effectively in the wake of the COVID-induced inflationary bout to mitigate the impact of runaway inflation. Brazil's central bank hiked rates 12 months before the first move by the US Federal Reserve. By moving so decisively, not only was inflation tamed in most EM countries, but many countries have also

benefited from positive real rates, offering attractive opportunities for investors.

Corporate credit quality in focus

Not only is the sovereign picture positive for emerging markets, the credit quality of the corporate universe has also been steadily improving.

EM companies can be characterised by more favourable debt metrics with lower net leverage levels and stronger interest coverage ratios. For investment grade corporates, on average leverage is less than 1x versus close to 3x in developed markets. Even in the HY space, EM debt metrics compare favourably to Western counterparts. This significantly reduces balance sheet risks. Indeed, expected defaults in EM corporates this year is 3.7% which is quite low, painting a positive fundamental picture.

EMs are home to some exceptionally strong names, such as Singaporean banks or the Qatar National Bank, which while not necessarily as large as US counterparts, are solid credits, that have been supported by liquidity and a strong macroeconomic backdrop while providing high yields. The risk/reward profile of EM credits looks stronger than that in DM.

This EM premium is likely to remain, despite the strong underlying fundamentals, as it's a less well understood market, diversified across many sectors and countries. This can provide a strong opportunity for investors with EM capabilities to take advantage of such dislocations.

Looking forward

Looking forward, we remain constructive on EMD. Fundamentals are improving across many markets, and we're seeing increasing signs that emerging economies are becoming less dependent on US policy cycles. Credible monetary and fiscal frameworks are becoming more widespread, helping to build investor confidence. We recognise that EM is no longer as defined by broad regional themes but by country-specific stories, policy credibility, and differentiated growth paths. This is where we see the greatest opportunity, particularly for investors who take a bottom-up approach to country selection.



¹International Monetary Fund, 'A Critical Juncture Amid Policy Shifts', (imf.org), April 2025.

²Reed Smith, 'Trump 2.0 tariff tracker', (tradecompliancesourcehub.com), September 2025.

³Fitch Ratings, 'Emerging market sovereigns benefit from net positive rating actions', (fitchratings.com), 18 October 2024.

⁴International Monetary Fund, 'Gross debt position', (imf.org), April 2025.

⁵Financial Times, 'Emerging markets has become a redundant term', (ft.com), September 2024.