Emerging market debt: investing at the cutting edge of global change

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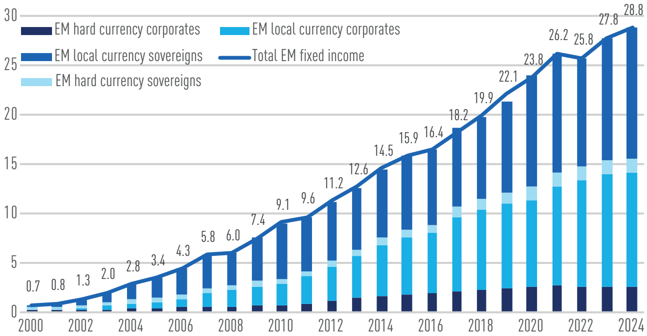
The emerging market debt (EMD) asset class has expanded dramatically over the past 30 years, when it consisted of a small set of countries in Asia, EMEA and Latin America. At the inception of JP Morgan's sovereign index in 1995, there were eight countries with USD government bonds included. The investible universe now consists of 109 countries with bonds issued in hard and local currency by governments, quasi governments and corporates. On the macro front, some emerging markets, including the UAE, South Korea and Chile have now grown so much such that their size, economic stability, quality of institutions and depth of financial markets are close to levels seen in G10 countries.

Meanwhile, the investible universe of EM fixed income has more than doubled in size in last 10 years, reaching around $29 trillion by the end of 2024. This growth has been driven by a widening range of issuers (sovereigns and corporates) across dozens of emerging countries becoming integrated into global capital markets. Additionally, more EM countries have seen foreign investors participating in their local market instruments, with new frontier local markets growth being notable in the last years of the post-global financial crisis expansion. Indeed, index providers have now developed frontier market specific indices, including for local markets.

The size of EM fixed income ($tn)



Source: J.P. Morgan, BAML, DMO, St. Louis Fed as at 31 December 2024

Investors are increasingly drawn by the diversification and yield premium EMD can offer. EM bonds on average carry higher yields (often 6-8% or more) than comparable developed-market bonds, yet the overall credit quality of the asset class is investment-grade on average.

Despite these positive dynamics, we feel many investors are still under-allocated to the asset class. EM dedicated funds and EM dedicated local funds (funds that are benchmarked to an EM bond index) have not had any material net inflows since the start of 2022. Despite this, EM countries and companies have continued to see demand for their bonds as other non-dedicated international investors have continued to buy EM bonds.

EMD has matured into a significant, dynamic asset class underpinned by the rising economic clout of emerging countries. With trillions in outstanding bonds and a diverse investor base, EM debt's growth story is closely tied to emerging economies' continued expansion. In our view, the current outlook points to steady economic growth across EM which provides a supportive environment for EM debt performance in the coming years. With improving fundamentals and prudent macro policies, we believe emerging markets debt is poised to play an even more prominent role in global portfolios going forward.

Index EMD: rising to the challenge of a growing universe

L&G launched its first index EMD product in 2011. Over that time, we've seen many market upheavals, from the taper tantrum in 2013 to the pandemic and the recent escalation of geopolitical tensions.

These episodes have tested the ability of index strategies to achieve their objectives and to maintain liquidity when it matters most. The result of this test has been unequivocal: index strategies have demonstrated their ability to provide cost-effective market access in all weathers.

The growth of the EMD universe has been a consistent theme throughout our time running money in this space. The inclusion of China and India in widely followed indices triggered a meaningful shift in global asset allocations, reflecting the increasing contribution of emerging markets to global economic growth.

We'd also highlight increasingly sophisticated integration of ESG as another way in which the EMD world is expanding. We have seen investors shift from simple exclusion lists through to a deeper integration via tilting mechanisms and more complex exclusion factors. At L&G, we have developed our own in-house sovereign risk ESG framework, which has been incorporated into several recent pooled fund launches.

Rather than adopting a 'passive' approach, we believe indexed EMD requires a proactive approach to manage index events, new issues, corporate actions, and changes to accessibility and sanctions.

Active EMD: capturing opportunities in dynamic economies

Over the past 11 years, L&G's active EMD team has grown substantially and is now international, with portfolio managers in Singapore and London, and Chicago in our sights. We are also ably supported by EM analysts in Hong Kong, Singapore, Chicago and London.

Our ability to execute EM trades is also truly global, with our offices in Hong Kong, London and Chicago effectively covering all necessary time zones. Over the years, we have primarily raised institutional money from Europe, including Germany, Switzerland and Italy. To increase our active EM reach, Uday Patnaik, our Head of Asia Fixed Income and Global Emerging Markets Debt has moved to Singapore for several years to help build up the investment side of the business and focus on growing our client service capabilities in Asia.

Today, we manage EM credit across multiple strategies, including blended (sovereign and corporates), investment grade only (both for sovereign and corporate sub-asset classes), high yield, EM buy and maintain, and EM absolute return. We launched our first Asia credit fund in April 2025, and this year we also won our first EM central bank mandate from an African country.

As our EMD offering to our clients grows, it's important that we keep abreast of the major global developments affecting EMs across the world, and what they could mean for investors.

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