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Marketing communication



EM debt: Cautious confidence in a shifting landscape

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Key takeaways

- With inflation falling across many emerging markets, central banks have begun adopting more accommodative stances, evidenced by rate cuts and declining average policy rates.
- A weaker US dollar since early 2025 has providing EM central banks greater flexibility, boosting the appeal of EM currencies and encouraging capital inflows into EM bond funds.
- While emerging markets have become adept at tuning out frequent policy noise, especially from the US administration, we remain alert to the risk of sudden shocks.

As we enter the final quarter of 2025, emerging market (EM) debt continues to demonstrate resilience against a complex global backdrop. Despite rising policy uncertainty, geopolitical tensions, and evolving trade dynamics, EM debt has largely outperformed other fixed income asset classes so far this year. In this note, we evaluate the drivers behind EM debt's strong returns, assess the sustainability of current trends, and outline the key risks and opportunities for the remainder of the year.

EM debt has delivered robust returns so far in 2025

EM debt has posted strong returns in 2025, driven by a confluence of supportive factors. With inflation trending lower across many EMs, central banks have begun adopting more accommodative stances,

evidenced by widespread rate cuts and declining average policy rates.

Earlier concerns about currency depreciation, especially against a strong US dollar, had constrained easing in some regions. However, the dollar's weakening since early 2025 has alleviated those pressures, providing central banks greater flexibility. This shift has boosted the appeal of EM currencies and encouraged capital inflows into EM bond funds.

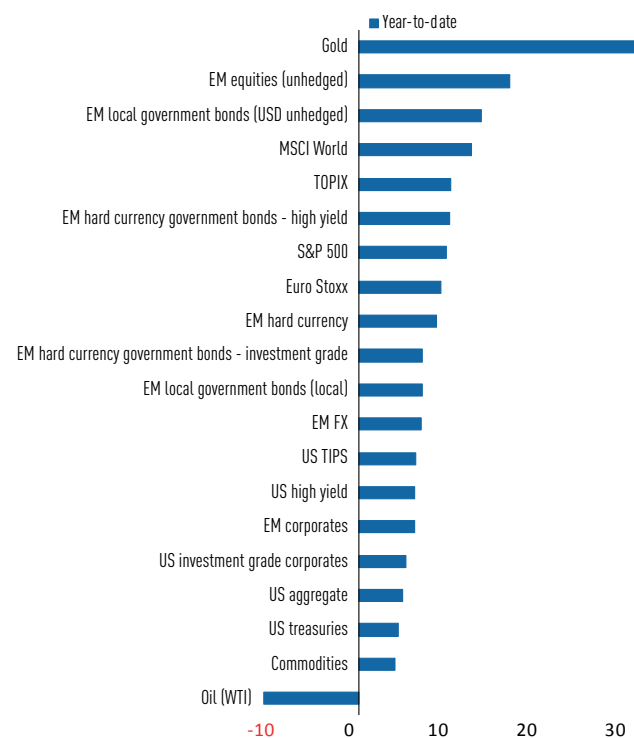
Developed market (DM) central banks have also continued to lower policy rates, providing EM central banks additional room to cut. During his remarks at the Federal Reserve's annual Jackson Hole symposium in August, Chair Jerome Powell indicated that a rate cut could be on the horizon. The baseline scenario assumes that tariffs will cause a one-off increase in the overall price level, rather than triggering a sustained inflationary trend.

Looser financial conditions should help mitigate some of the pressures stemming from China, which, unlike in previous cycles, has so far avoided large-scale retaliatory stimulus measures. In addition to subdued Chinese demand, EM exporters are grappling with prolonged producer price deflation. This has led to steep discounts on Chinese goods, intensifying competitive pressures.

Despite these headwinds, global growth has remained relatively resilient. Even in Asia, the world's largest exporting region, export volumes have held steady. This stability may reflect factors such as trade rerouting, transshipments, or the front-loading of orders.

As for EM sentiment, markets have largely discounted tariff announcements, viewing them as more disruptive in theory than in practice. The lack of clarity and frequent changes have desensitised investors, sustaining a recurring relief rally.

EM debt has held up well so far this year (%)



As at 31 August. Source: Bloomberg

Past results are not a guarantee of future results.

Uncertainties on the horizon

While results so far have been encouraging, several risks could challenge EM debt's trajectory through year-end:

1. US growth headwinds

As tariff levels become more defined, the impact on growth is likely to materialise. Tariffs can raise input costs for consumers and businesses, potentially moderating consumption and investment. A softer US growth outlook may weigh on investor sentiment and global demand, potentially affecting capital flows into EM. The ongoing AI revolution could provide a counterbalance, offering productivity gains, although its implications for labour markets are still evolving.

2. Geopolitical volatility

Geopolitical dynamics remain a key consideration for investors, with ongoing regional tensions and evolving international relationships shaping the global landscape. Tariffs, once primarily economic tools, are increasingly being used within broader strategic frameworks, reflecting the complex interplay between trade and diplomacy. This shift introduces greater unpredictability, as tariff decisions are now influenced by broader considerations.

At the same time, some EM leaders appear to be observing and adapting elements of the US administration's approach to economic and foreign policy, potentially reshaping their own strategic frameworks in response. Encouragingly, tariffs being used more for geopolitical goals implies that such measures may be reversible, depending on the strategic alignment between nations. The current environment also requires EMs to prioritise sound domestic policy, maintain flexibility to respond to shocks, and cultivate strong trade and diplomatic relationships.

3. Market complacency and shock risk

Markets have become more accustomed to frequent policy announcements, which has helped dampen short-term volatility. However, this sense of stability may leave investors more exposed to unexpected shifts – whether from major policy changes or geopolitical developments. In such instances, EM assets, given their higher sensitivity to market movements, could experience more pronounced reactions.

Structural trends could support EM debt over the longer term

Some of the above challenges are familiar territory for EM investors, who routinely assess and calibrate such risks. This is one of the key reasons EM assets often command a significant risk premium. As global standards begin to align more closely with EM dynamics, the relative value of EM exposure may continue to be recognised. In fact, EMs are increasingly viewed as being on a relatively stronger footing, especially when it comes to fiscal dynamics.

While fiscal vulnerabilities have long been a focal point in EM, rising pressures in DM, particularly in countries like the UK, US, and France, are shifting the narrative. EM economies, meanwhile, have strengthened their domestic policy frameworks since the pandemic, building buffers and enhancing credibility.

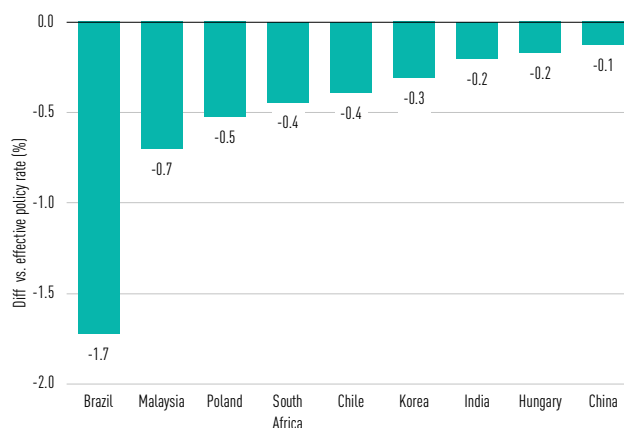
Artificial intelligence and digital innovation are also changing the landscape for EM, with implications for labour markets, trade flows, and productivity. The potential for leapfrogging and structural transformation is significant, especially given the absence of legacy systems, which could allow for agile adoption.

How we are investing around these themes

Our current investment approach is centred on capturing carry opportunities while remaining selective and risk aware. We see some value in EM exchange rates, particularly in Latin America and Central and Eastern Europe, where valuations remain compelling. We are also favouring local duration in markets with well-anchored inflation and attractive yield curves. Credit positioning is neutral, reflecting a

Lower inflation prompts rate cuts in some markets

1 year expected change in policy rate (%)



Data as at 31 August 2025. Source: Bloomberg

disciplined stance amid tighter spreads.

While markets have become adept at tuning out frequent policy noise, especially from the US administration, we remain alert to the risk of sudden shocks. A sharp shift in policy or an unexpected geopolitical event could trigger a broad risk-off move, with EM assets likely to bear the brunt due to their higher sensitivity.

Kirstie Spence is a fixed income portfolio manager at Capital Group. She also serves on the Capital Group Management Committee. She has 29 years of investment industry experience, all with Capital Group. She holds a master's degree with honours in German and international relations from the University of St. Andrews, Scotland. Kirstie is based in London.

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- Past results are not a guide to future results.
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- Depending on the strategy, risks may be associated with investing in fixed income, derivatives, emerging markets and/or high-yield securities; emerging markets are volatile and may suffer from liquidity problems.

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