Emerging market local-currency bonds continue to look bright in 2026

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Despite our reduced conviction in a weaker USD for 2026, we believe emerging market (EM) local-currency bonds remain well-positioned. Ongoing disinflation in EM economies not only supports EM currencies but should also enable some EM central banks to cut interest rates in 2026. We believe EM FX can perform well even with a sideways USD given the healthy state of external accounts in most EM countries.

In 2025, EM local-currency bonds posted a 19.3% total return (valued in USD), the highest among EM fixed income and the best since 2009. While the asset class performed well throughout the year, its outperformance relative to EM hard-currency peers was primarily driven by a 10.4% decline in the USD during the first half of the year. In the second half of 2025, total returns for EM local-currency bonds were between EM corporate bonds (CEMBI BD) and EM hard-currency sovereign bonds (EMBIG Diversified).

We have maintained a bearish outlook on the USD and a bullish stance on EM local-currency since Liberation Day, driven by four factors:

1. Expectations that the US economy would be more adversely affected than the rest of the world by the imposition of tariffs on its trading partners;
2. Narrower interest rate differentials, as a weaker US economy would prompt the Fed to resume rate cuts while other developed market (DM) central banks remain on hold or are hiking rates (e.g., the Bank of Japan);
3. Diminished confidence in US institutions due to unpredictable policies; and
4. The disinflationary impact of tariffs on the rest of the world.

These macroeconomic factors remain relevant today. However, our conviction in a weaker USD is not as strong as it once was.

EM local-currency is well positioned, even if the USD does not weaken further

Although traditional macroeconomic trends suggest a weaker USD, the ongoing AI boom may continue to drive capital flows into US equity markets, potentially offsetting some or all of the relative macroeconomic weakness in the US. It is difficult to quantify the net effect of these two opposing forces. Therefore, we currently expect the USD to either remain range-bound through 2026 or to weaken further, albeit not as much as in 2025.

That said, EM local-currency bonds can still perform well even with a stable USD, as demonstrated in the second half of 2025. The USD began trading sideways from the third quarter once it became apparent that trade deals were forthcoming, recovering by +1.5% in the second half (as measured by the US Dollar Index (DXY)). Despite this, and at the same time, EM local-currency bonds delivered a healthy 6.4% return during this same period, positioning them between EM corporate bonds (4.5%) and EM hard-currency sovereign bonds (8.2%).

In fact, EM foreign exchange (FX) returns – the portion of the local-currency index performance attributable to pure currency gains – was +1.7% in the second half of 2025 even though the USD strengthened by 1.5% (as measured by the DXY) against major global currencies. We believe this highlights that the asset class is well positioned to continue delivering solid returns, even if the USD does not weaken further.

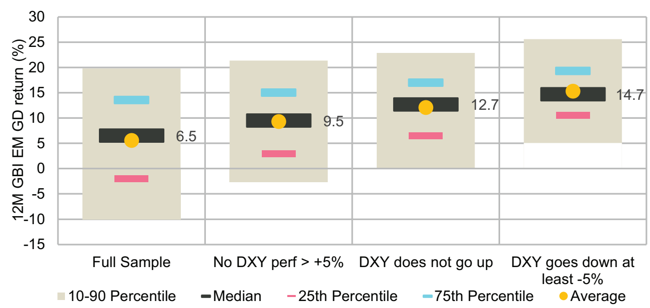
To explain why we remain bullish on EM local-currency bonds despite our reduced conviction in a weaker USD, we will adopt two perspectives. First, we will take a historical approach by reviewing over 20 years of performance for this asset class across different USD regimes. Second, we will examine EM-specific factors that are likely to support the asset class's performance in 2026.

Looking at more than 20 years of data for EM local-currency, we observe a median annual return of 6.5% (in USD) since 2003, with a wide range of returns (see the "Full Sample" column in Chart 1). When we exclude periods during which the USD rallied by more than 5% over a 12-month period, the median return increases to 9.5% (see the "No DXY" perf > +5% column). If we further eliminate all periods of USD rallies, the median 12-month return for the asset class rises to 12.7% (see the "DXY does not go up" column). Finally, periods when the USD declined by at least 5% (such as 2025) the median 12-month return for the asset class increases to 14.7%.

Given the macro environment described above, we believe it is unlikely that 2026 will experience a USD bull run. Therefore, this historical perspective suggests relatively high return expectations for EM local-currency bonds.

Chart 1: EM local-currency bonds (GBI-EM) performance since 2003 by USD regime

12-month GBI-EM GD return distribution given different USD (DXY) scenarios



Sources: Bloomberg, Vontobel calculations; data from January 2003 until September 2025.

Statistics don't drive returns, so let's examine factors likely to support EM local-currency bonds in 2026. At the index level, GBI-EM's 5.9% yield-to-maturity may seem relatively low but reflects higher average credit quality

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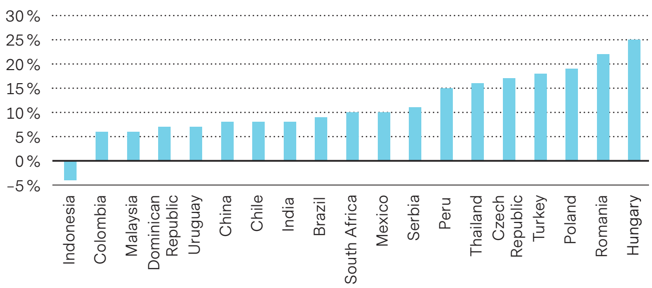
and a bias toward low-yielding Asia, suggesting slightly lower return expectations compared to its hard-currency counterparts, assuming no significant market developments occur over the next 12 months. However, markets are constantly evolving, so while yield-to-maturity is a reasonable predictor of expected returns over the long term, it is less reliable over a shorter 12-month horizon. Our macro outlook anticipates that the USD will likely remain range-bound, as it has over the past five months, or potentially decline further, perhaps by one standard deviation (4.8%).

Furthermore, we believe EM FX has a strong chance of outperforming major non-USD developed market currencies due to two key factors. First, EM inflation is typically higher than DM inflation – which leads to nominal EM FX depreciation over the long-term. However, the current inflation differential between EM and DM is minimal: most of Asia is experiencing either deflation or significantly below-target inflation; South Africa recently lowered its inflation target to 3% (from 4.5% ± 1.5%); and inflation expectations in Brazil are finally declining.

As a result, the GBI-EM Index inflation expectation calculated using 2026 IMF forecasts dropped to 3.1%, only a little above the 2.4% expected for the US. Therefore, while nominal yields for EM local-currency bonds may not appear particularly high, they are quite attractive in real terms (when accounting for relative inflation). Moreover, this ongoing disinflation in EM economies not only supports EM currencies but should also enable EM central banks – such as those in Brazil, South Africa, Hungary, and Poland – to cut interest rates in 2026, likely resulting in duration gains for EM local-currency bonds.

A second reason we believe EM FX can perform well even with a sideways USD is the healthy state of external accounts in most EM countries. Over the years, the composition of the local-currency index has shifted, with the aggregate now representing a net oil importer. Currently, low oil prices, combined with elevated copper prices, are creating favorable terms of trade and enabling the accumulation of FX reserves across nearly all countries in the index (with the exception of Indonesia; see Chart 2). This is positive for EM FX performance and also strengthens these countries' ability to service external debt.

Chart 2: Change in international reserves since December 2024



Source: Macrobond; data as of October 2025.

Slightly more optimistic outlook for EM local-currency over EM hard-currency bonds

In summary, we believe the current macroeconomic environment remains favorable for this asset class, despite our conviction in a USD bear market being lower than it was a few months ago. That being said, given benign fundamentals we see no reason to expect returns to be different from the average of our long term conditional distribution (+9.5% see Chart 1). We anticipate total returns for the asset class to range between 7% and 12%, exceeding thus the current yield, driven by a combination of EM FX returns, lower EM interest rates and some roll-down, which support bond price appreciation. This outlook is somewhat more optimistic than our return expectations for hard-currency bonds, where already tight spreads limit upside potential – unlike the current valuations in EM FX.

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