

Emerging market debt: strength and selectivity amid global shifts

Emerging market fundamentals remain robust, but broader global macroeconomic developments are leading us to a more selective approach to positioning portfolios.

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The past – what just happened?

Despite recent equity market volatility, emerging market debt (EMD) has maintained its strong momentum over 2025, delivering strong returns. As of 31 December, EM hard currency sovereign bonds gained 14.30% year-to-date, while corporates were up 8.72%. These results have been driven primarily by movements in US Treasuries – benefiting sovereigns in particular – alongside additional support from spread tightening, especially within the high-yield sovereign segment. EM local markets outperformed over the same period, posting a 19.3% return, supported by a weaker US dollar.

The present – positioning and performance

With resilient growth across emerging markets as per the International Monetary Fund, declining inflation and a robust external sector, we maintain our constructive stance on EMD. Our confidence is underpinned by structural improvements now being reflected in credit rating trends. Upgrades have outpaced downgrades in 2025, signalling positive momentum. There were no sovereign defaults in the last two years. We expect aggregate default probability to be very low in 2026 whereas EM corporate default is forecasted at less than 3% in 2026¹.

From a valuation perspective, spreads have tightened steadily throughout the year, leaving us asking the recurring question: how tight is too tight as they approach historic lows?

Current sovereign spread levels are comparable to the early 2018 tights. That said, everything is relative; at these levels, EM spreads still provide a pickup over US investment grade (IG) credit, given that spreads in the US IG space have also compressed.

We've also observed improving investor sentiment towards EMD. Global liquidity conditions have strengthened, and after years of significant outflows EMD funds are now seeing renewed inflows. Notably, crossover investor allocations to EMD rose from 8% to 15% over the past three years².

Key risk

Assumptions, opinions, and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

¹JP Morgan, November 2025; ²Bank of America, November 2025

Key risk

Risk management cannot fully eliminate the risk of investment loss. Assumptions, opinions and estimates are provided for illustrative purposes only.

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Outlook

Given this backdrop, we see limited risk of a sharp widening in EM spreads. Despite record issuance this year, spreads have compressed, indicating strong demand for the asset class. Even CCC-rated country issuers such as Suriname, Laos, and the Republic of the Congo have successfully accessed markets, underscoring investor appetite for EMD.

With subdued growth, a softening labour market, and weak oil prices in the US, we, like other market participants, also anticipate continued rate cuts by the Federal Reserve. This should help keep rates from rising meaningfully, supporting our expectation of mid-to-high single-digit total returns in EMD for 2026. As a result, we maintain our +1 credit score.

What could go wrong?

Looking ahead, key risks for EM in 2026 are likely, in our view, to stem from US markets and macroeconomic developments – particularly a possible resurgence in inflation, elevated AI-driven equity valuations and high levels of AI issuance posing a headwind for US investment grade (and hence EM investment grade).

Recent volatility in US equities has already had spillover effects on EMD and broader risk assets in the fourth quarter of 2025, and we remain cautious of similar episodes in 2026. Consequently, our positioning is more selective than in previous cycles, with a focus on idiosyncratic opportunities (for example, oil importers and precious metal exporters) rather than broad beta exposure.

This article was written before the US intervention of Venezuela. Read our blog (blog.landg.com) to find our views on the potential impact on markets.



Source: L&G as at 31 December 2025 – can be subject to change at any point.

