Redrawing the map of sovereign investing

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For much of the past two decades, the case for developed market government bonds at the centre of fixed income portfolios rested on three assumptions: inflation would remain contained, central banks would provide a dependable source of demand, and rising sovereign debt would be readily absorbed. Each now looks less secure.

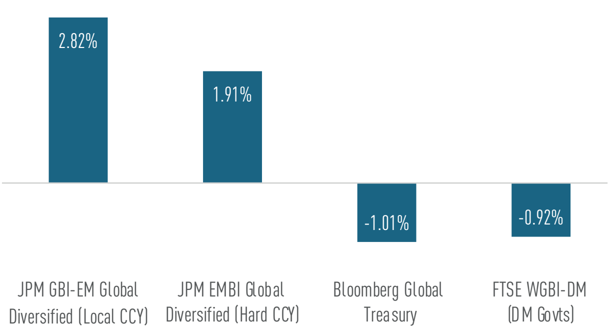
US federal debt surpassed $40 trillion in August 2026. The deficit remains above 6% of GDP, while publicly held debt has crossed 100% of GDP for the first time since the aftermath of the Second World War and is projected to reach 139% by 2030. Europe is not immune to these developments either: France's debt-to-GDP ratio reached 115.6% in 2025, Italy's 137.1% and the UK's 101.3%. Germany, long regarded as the region's fiscal anchor, sold 30-year bonds in August at 3.8%, the highest yield since 2011.

If bond vigilantes are indeed re-emerging, benchmark construction may matter more than many investors assume. Sovereign indices with lower exposure to these core developed market issuers outperformed in the first half of 2026 as longer term yields rose. While too early to call a structural trend, the episode illustrates how concentration risk can be amplified when fiscal supply expands and term premia begin to normalise from unusually low levels.

The core is already moving

Benchmark selection is an important component of any strategic fixed income allocation, whether implemented through active or passive strategies. Different benchmarks embed different country exposures and risk characteristics. The FTSE World Government Bond Developed Markets Index, for example, allocates now close to half its weight to the United States. This reflects the impact of a growing debt burden under a market-capitalisation-weighted methodology.

Year-to-date performance of key sovereign debt indices in USD



Source: Bloomberg Finance L.P., as of 13 September 2026. Indices shown: FTSE World Government Bond Index (WGBI) USD, Bloomberg Global Aggregate Treasuries Total Return Index Value Unhedged USD, J.P. Morgan EMBI Global Diversified Composite and J.P. Morgan GBI-EM Global Diversified Composite Unhedged USD. Past performance is not a reliable indicator of future returns.

Exchange rate movements can also play an important role. Japan provides a useful example. While the stock of Japanese government debt has continued to grow, prolonged yen depreciation reduced the dollar value of that market and, in turn, Japan's representation within global sovereign benchmarks. Japan's weight in the Bloomberg Global Treasury Index has declined from more than 20% at its peak to 13.8% today, despite a debt-to-GDP ratio exceeding 206%. Benchmark exposures therefore evolve not only in response to new debt issuance, but also through changes in relative market valuations and currency movements.

Both effects strengthen the case for looking beyond a narrowly defined developed market universe. The widely followed Bloomberg Global Treasury and ICE Global Sovereign indices extend the investment-grade opportunity set across a broader group of issuers. The Bloomberg index currently allocates around 35% to the United States and 14% to Japan but also 11% to China. China's inclusion brought the world's second-largest government bond market into mainstream sovereign benchmarks and added a monetary cycle that has often diverged from those of the United States and Europe. That diversification is difficult to replicate within developed markets alone.

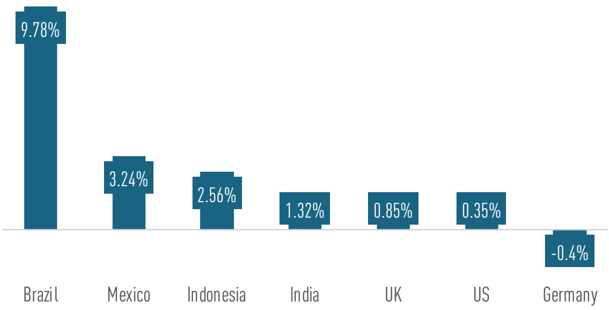
India, which is already a member of the ICE benchmark, shows how that boundary is continuing to move. Indian government bonds entered JPMorgan's GBI-EM Global Diversified Index in June 2024, reaching the 10% country cap by March 2025. Bloomberg began adding eligible securities to its EM Local Currency Government indices in January 2025, and FTSE Russell followed through its emerging market government bond range. Inclusion in the flagship global aggregate indices remains more limited, for now.

Local Currency EMD Is More Than a Yield Story

This gradual expansion of benchmark inclusion has strengthened the case for local-currency EMD as a strategic allocation rather than a purely tactical one. The conventional playbook would have viewed 2026 as a challenging environment for the asset class: a stronger US dollar, elevated global yields and persistent geopolitical uncertainty. Yet the JPM GBI-EM Global Diversified Index returned 2.82% year to date and 6.08% over one year in US dollar terms. Higher real yields help explain that resilience. Policy rates remain comfortably above inflation in several large emerging economies, providing both income and a cushion against moderate currency or duration shocks. Brazil's real policy rate stands at roughly 9.8%, Mexico's at 3.2%, Indonesia's at 2.6% and India's at 1.3%. By comparison, the US real policy rate is around 0.4%, while Germany's is approximately -0.4%.

The investment case, however, extends beyond headline yield. A recent OECD study highlights how many emerging economies have responded to the crises of the 1990s and early 2000s by adopting

Real Policy Rates (%)



Source: Bloomberg, as of 07/09/2026. Real policy rate calculated as the current central bank policy rate minus latest available CPI inflation.

more flexible exchange-rate regimes, extending debt maturities and developing deeper local investor bases. Greater reliance on domestic-currency borrowing has reduced dependence on external financing and lowered currency-mismatch risks.

As a result, local-currency EMD increasingly offers investors three sources of return: income through higher real yields, diversification through differentiated monetary and economic cycles, and potential currency appreciation where fundamentals improve. For strategic allocators, that combination forms a distinct component of the global fixed income opportunity set.

None of this makes EMD a single trade. For institutional investors, the challenge is therefore not to assign a single strategic weight to EMD. It is to distinguish between the underlying exposures: which markets can provide diversified risk, which belong in a return-seeking allocation and which still carry the liquidity or credit characteristics traditionally associated with a satellite position.

A framework for thinking about sovereign allocation

Taken together, these developments suggest that the traditional boundary around the sovereign core is becoming less clear. A developed-market-only approach was easier to justify when fiscal positions were stronger, benchmark concentration less problematic and investable alternatives more limited. As large emerging sovereign markets deepen and become more accessible, classification alone provides a weaker guide to their potential portfolio role.

Going forward investors may want to assess sovereign exposures by credit quality, market depth, policy credibility and diversification potential – rather than an DM/EM label. The growing passive toolkit makes that assessment easier to reflect in portfolio construction, without forcing investors into an all-or-nothing choice between a developed market core and an EMD satellite.

Broad sovereign ETFs can provide diversified exposure across countries, currencies and monetary cycles through a single allocation. More targeted country or regional building blocks can then be used to adjust exposures around that base. This can be particularly useful where direct access, custody, settlement or trade sizes have historically constrained participation. Index-based exposures therefore offer more than implementation efficiency: they can provide a practical route into markets that remain emerging by classification, but are becoming more established in terms of liquidity, accessibility and potential relevance to the core.