Oil shock; six months on, the EM debt bid remains strong

Carlos de Sousa, EM Debt Strategist and Portfolio Manager, Vontobel

In April, we argued that emerging markets (EM) fixed income was better positioned to withstand the oil shock than it had been in 2022 and that we believed the asset class was poised for a strong rebound if de-escalation occurred within a relatively short time frame. De-escalation took longer than both we and the markets had expected, with the full-blown war lasting much longer and remaining unresolved. Yet the rebound thesis was correct.

The Strait of Hormuz partially reopened in June, then closed again in July. At the time of writing in early September, its status is uncertain, given that a significant volume of trade has gone dark, with vessels switching off their transponders . Oil prices are off the heights seen in March and April but remain more than 50% above their levels at the start of the year. Despite this, the inflation shock has been milder and shorter-lived than expected and is likely to fade faster than it did four years ago. As a result, pre-war trends have returned, as expected. Inflows into EM fixed income were interrupted only in March and resumed in April, while the credit rating upgrade trend we had been observing continued through Q2 and Q3 despite the war.

The second global inflation shock that markets were pricing in back in March did not materialize with anything like the magnitude of 2022. Headline inflation spiked, but core measures remained broadly anchored. While some EM central banks raised rates, most did not need to, and certainly not to the extent markets had priced in back in March. This likely reflects the considerable credibility they have built over the past four years relative to their developed-market peers.

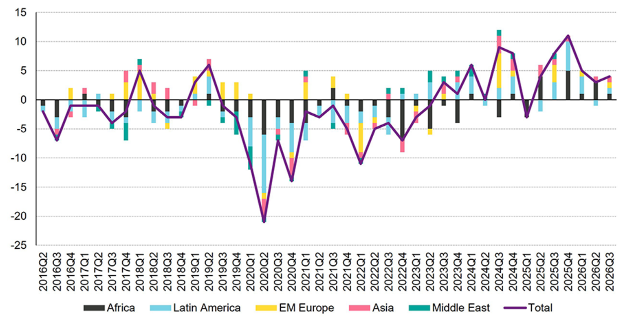
This outcome vindicates the core argument of our April article. After four years of restrictive monetary policy globally, the pass-through from an oil supply shock to consumer inflation is structurally smaller than it was in the aftermath of the pandemic, when policy was extremely loose and aggregate demand was rebounding amid supply constraints. This more muted inflation shock, combined with yields that remain elevated, has allowed the asset class to remain resilient and deliver positive YTD returns, a sharp contrast to the double-digit negative returns of 2022. Moreover, recent inflation data suggest that this inflation cycle will also be much shorter-lived than the 2022 cycle, which would bode well for fixed income.

EM fundamentals have remained resilient through the war-induced shock. Over the past year and a half, we have highlighted the strong trend of sovereign rating upgrades. Impressively, this trend continued unabated during the past six months despite the war.

Two major downgrades took place in Latin America (Colombia and Mexico) driven by long-term fiscal deterioration that was unrelated to the war and was largely anticipated. Meanwhile, several countries continued to be upgraded on the back of medium-term structural reforms, with upgrades occurring across the rating spectrum and across all regions.

One of the common trends driving rating upgrades at a global level has been the accumulation of international reserves across continents. There was a risk that some EM central banks would make use of these reserves to defend their currencies. Only the Turkish central bank did so to a significant degree in order to defend the Turkish lira's crawling peg, which is key to its disinflation program.

Figure 1: Emerging market sovereigns continue to receive credit rating upgrades



Source: Bloomberg and Vontobel calculation, data as of 24.08.2026, Q3 2026 data is partial (up to 24.08)

The other relevant pre-war trend, inflows into the asset class, also resumed after a brief interruption in March. As the oil shock faded and risk appetite returned, the pre-war inflow trend regained momentum, with significant flows into the asset class during each month in Q2 and Q3. Crucially, the AI boom that has supported a stronger-than-expected US economy and a rebound in the US dollar has not derailed this trend. Global asset allocators appear to remain focused on seeking geographical diversification away from US-centric portfolios, a dynamic that we identified as structurally supportive of the asset class.

Global risk appetite remains elevated, and we expect this to remain the case for the remainder of the year, which would bode well for EM fixed income. EM hard-currency sovereign and corporate spreads are now tighter than their pre-war levels in February. Therefore, the potential upside coming from spreads is now more limited in aggregate, although there are still ample relative-value opportunities. And with the two previous trends now back in place, we think that tight spreads are likely to persist for longer.

Oil-related relative value trades have been abundant this year. Nine months ago, market sentiment toward oil prices was negative, and spreads from oil-exporting high-yield (HY) countries and oil companies were very elevated. At the time, we interpreted this as an asymmetric opportunity with greater upside than downside, given already depressed valuations for oil and oil-related issuers. By March, HY oil importers underperformed due to high oil prices, despite expectations that the conflict would be short-lived. By June, however, oil prices tumbled, and oil importers were once again outperforming exporters.

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What we now see is that oil exporters are in a stronger position than before the war, as the average oil price for 2026 is poised to remain substantially higher than the market expected at the start of the year. Oil-exporting sovereigns and oil and gas companies are likely to see stronger fiscal and external accounts this year, with some of them deleveraging significantly. Oil-importing nations should still see some external (and, in some cases, fiscal) deterioration in 2026. Yet spreads for most are back to their pre-war lows. The devil is in the details, and outcomes will vary on an issuer-by-issuer basis.

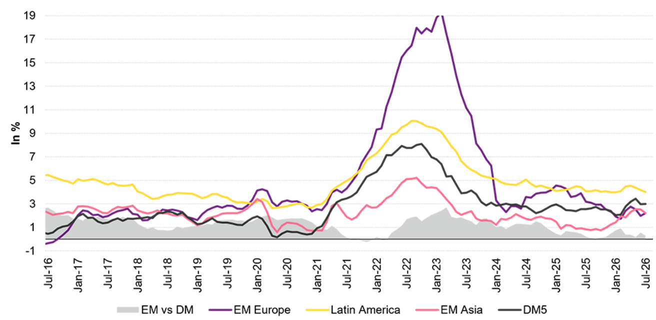
The dollar conundrum makes EM local currency tactically challenged but structurally well supported. An interesting tension for the second half of 2026 is the coexistence of a tactically strong dollar with structurally attractive EM currencies and rates. The US dollar has been supported by decent US growth performance and the AI investment boom, which has drawn capital toward US assets. Another factor is that Fed Chair Kevin Warsh is far more difficult to read than his predecessors, in our view. In one statement, he may sound dovish and markets react accordingly, and in the next, he may sound more hawkish than expected and markets reverse the previous move. Unlike last year, when EM local assets had a stellar performance of almost 20%, this year they performed in line with hard currency, rising by 2.75% (in USS) during the first eight months of the year. That said, the asset class has managed to deliver positive returns (measured in USD) despite the ongoing global rise in long-dated yields. Several key themes continue to support the asset class.

Tactically, predicting dollar moves is a tricky business, but we believe elevated global risk appetite will also attract capital to carry trades in local-currency, including frontier markets. In fact, four high-yielding Latin American currencies – the Colombian peso (COP), Brazilian real (BRL), Argentine peso (ARS), and Dominican peso (DOP) – have delivered double-digit USD returns YTD. The Turkish lira carry trade and a few African local-currency markets have also delivered double-digit returns.

Strategically, we view the asset class as relatively attractive. While hard-currency spreads are historically tight, local-currency real rates are near one standard deviation above their 10-year median. Moreover, the aforementioned diversification trend extends beyond credit risk and geographical diversification through EM hard-currency and encompasses currency diversification as well.

Finally, we believe that lower structural inflation in EM relative to developed markets (DM) is a powerful long-term tailwind for EM local assets. Now that EM inflation is much closer to DM inflation (see grey area in Figure 2), EM currencies no longer need to depreciate in nominal terms at the same pace as they did before the pandemic.

Figure 2: Emerging vs developed market inflation differentials remain low (grey area)



Source: Macrobond data and Vontobel calculations, data as of end-July 2026

Back in April, we were cautiously optimistic given the very high uncertainty. With much of the uncertainty now resolved and the positive EM trends reasserting themselves as we had expected, we have returned to a similar level of optimism to what we had pre-war. However, we are a bit more selective than before, given tighter valuations and some unresolved uncertainties.

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