March 2025

Emerging Market Debt Outlook:
All Roads Lead to the US

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The start to 2025 has been anything but boring for the world's financial markets and especially so for the emerging markets. But as the world adjusts to the shifting geopolitical realities, our outlook for Emerging Market Debt (EMD) remains constructive for the rest of 2025. Within our positive view on EMD, we hold greater enthusiasm for hard currency over local currency debt.

Our outlook is built on our overall house view on the global economy, which pays close attention to developments in the United States. Politically and economically, we recognize that the machinations of what takes place in Washington, D.C. will have repercussions for risk assets around the world, and particularly for those in emerging economies. From geopolitics to trade wars to monetary policy, all roads lead to the US.

A Brief Recap: Emerging Market Debt in 2024

Before we expand on the prospects for emerging market debt, a look at the lead up to current market conditions and a recap of recent performance drivers is worthwhile. The resilience of the US economy through 2024 was a key factor as robust growth and a slower-than-expected drop in the pace of inflation helped keep the Federal Reserve (Fed) in cautious mode until September, when it announced its first rate cut of the cycle. It followed up with two more cuts by year-end (for a total of 1.00% in cuts) as it seemed clear that inflation was close to bottoming out. This comparatively slower pace of US rate cuts kept the US dollar buoyant versus other currencies while the US Treasury yield curve reshaped from a two-year inversion to a more normal upward-sloping curve. And then in November, the election of Donald Trump as US President signaled a clear mandate for change — and change and uncertainty has been a feature in the months since.

For hard currency EMD, the asset class returned 6.54% (in USD terms) in 2024, as measured by the JP Morgan EMBI Global Diversified index, driven by strong performance in high yield sovereigns which returned 13.00%.[1] Robust performance in the deeper parts of the market was driven by several idiosyncratic situations that found some form of resolution in the year — boosting returns through earned carry or price performance from low levels. Examples of this included:

- Egypt received a vital lifeline from the United Arab Emirates
- Argentina's fiscal and monetary discipline was rewarded by the market
- Sri Lanka, Ghana, Ukraine, and Zambia successfully restructured their debt.

Investment grade (IG) debt returned only 0.32% for the year, with a slight widening of credit spreads and increasing Treasury rates offsetting current yields.

Strong currency headwinds detracted significantly from local currency debt performance, which posted a negative return in 2024 of -2.38% (in USD terms) as measured by the JP Morgan GBI-EM Global Diversified index. Indeed, currency weakness detracted -7.73% from overall returns, effectively cancelling out the carry from this asset class. Although high real yields were evident in some countries, most EM central banks cut rates cautiously in an effort to strike a balance between tighter monetary policy and currency weakness.

Key Themes for EM Debt in 2025

Despite the headline risks, we believe that there is a constructive environment for EMD. Within this view, we continue to have a preference for Hard Currency (HC), although extended USD weakness from the heights of last year could support Local Currency (LC).

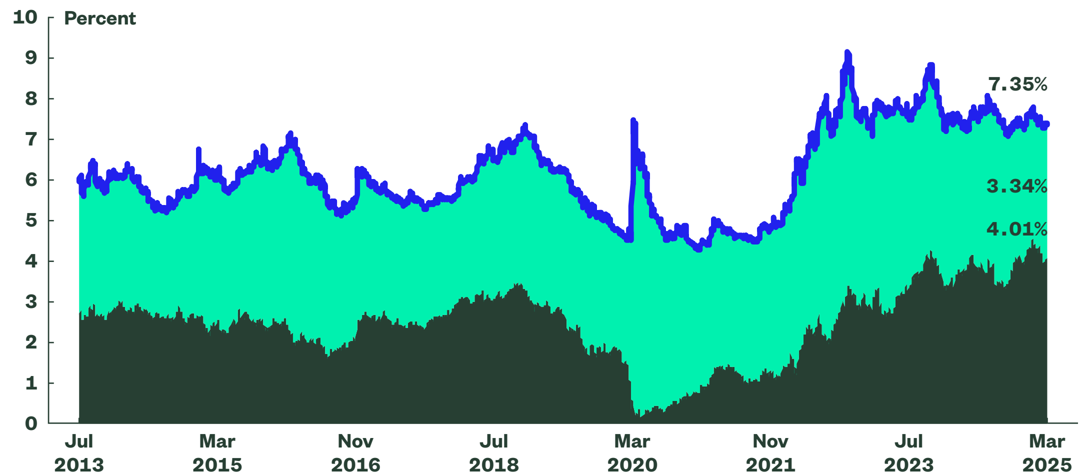
The macro backdrop is largely favorable, with additional rate cuts and a soft economic landing envisaged. These conditions are generally positive for fixed income and we expect government bonds across most advanced economies to provide attractive returns. We believe that emerging market debt also offers value, although investors need to be comfortable with a more volatile external environment, from both a policy and currency perspective, that is likely to prevail throughout 2025.

"Goldilocks" Scenario for EM Debt

We expect to see the soft landing scenario anticipated for 2024 to play out in 2025, with decelerating growth in the US incentivizing the Fed to persevere with rate cuts. This would present a Goldilocks environment for EM debt where EM spreads are supported, while lower Treasury yields and a weaker US dollar become important tailwinds for EMD returns.

Figure 1
EM Spreads Offer Support

US Treasury Yield
EM Spread (OAS)
HC EM Yield



Source: State Street Global Advisors, JP Morgan as of 19 March 2025. Past performance is not a reliable indicator of future performance.

Hard Currency EMD The investment grade (IG) portion of the asset class would benefit from a decline in Treasury yields. Meanwhile, high yield (HY) could continue to see positive outcomes from possible country-specific events such as :

- Lebanon could form a new government and address its debt burden
- Argentina inflation may abate paving the way for growth to finally take hold
- Ecuador run-off elections in April to provide clarity on economic and fiscal trajectory
- International Monetary Fund (IMF) reviews expected for Pakistan, Kenya, Lebanon, and El Salvador, among others.

A benign backdrop would also mean that new funding via primary market activity can take place, even for non-IG issuers. While contingent on market conditions and sentiment, evidence of primary market activity would augur well for overall EMD returns.

Local Currency EMD The rationale for Fed rate cuts should also dampen the US dollar's high valuation and allow EM currencies to at least stabilize, and then potentially appreciate. Should a faltering US economy require more aggressive rate cuts by the Fed, EM central banks would also have scope to cut rates and help generate additional performance from rallying bond yields.

If "Goldilocks" Does Not Hold

It is important to also consider how EMD would behave if the soft landing scenario does not play out. Tariffs, geopolitics, and fiscal strength are expected to be the main drivers of the US economy this year, and all have potential ramifications for EM economies. In a "no landing" scenario for the US, we would expect continued weakness in local currency debt as renewed USD strength would pressure EM FX; tariffs could also have an outsized impact on specific EM countries and act as an accelerant to devaluation for some EM currencies. Meanwhile, EM hard currency would be better insulated but would still have limited ability to deliver meaningful returns, especially if some countries are caught in geopolitical crosshairs. Moreover, the likelihood of US Treasuries rallying and offsetting any spread sell-off would also be lessened.

Trump: Lots of Headlines, All the Time

The second Trump administration has hit the ground running, with a flurry of activity on tariffs, geopolitics, and fiscal policy — all important drivers of growth and ultimately monetary policy. The market has been processing a multitude of headlines and policy actions (with some delays and reversals) that have direct implications for sentiment and performance of risk assets. This unprecedented and uncertain policy backdrop could lead to an environment of elevated volatility in risk assets as skittish investors grapple with the consequences of these policies.

Tariffs: More Bark Than Bite?

President Trump may be using tariffs as a negotiating tactic to achieve his domestic growth goals, but it is still too early to determine if this will be successful. Countries with trade surpluses with the US appear most at risk to such actions — these include China, Canada, Mexico, Japan, and most of Europe. The tariffs imposed thus far have impacted US companies the most, driving up costs. However, more comprehensive tariffs that harm US consumers could curtail spending and dampen the very growth this administration is trying to spur. Moreover, a slowdown in global growth could ensue as companies and consumers around the world rein in investment and spending. Put simply, tariffs need to be calibrated correctly to be effective, which is why we think they could be more bark than bite.

Geopolitics: Upside and Downside Risks

On the geopolitical front, President Trump has so far intervened in two major conflicts: Israel/Gaza and the war in Ukraine. However, the market outcome for impacted parties may not be fully understood until well after the fact. In the Gaza conflict, the role that Arab countries play in any resolution is just as important as the economic contribution that a growth backdrop could provide. For Ukraine, we do not yet know what its future might look in terms of borders or leadership, nor what the implications could be for neighboring countries in Europe. Meanwhile, the Trump administration will also be monitoring China's ambitions in the South China Sea. The threat to the global economy should not be underestimated given the importance of China and the wider region to global growth.

US Fiscal Policies

We are also watching the fiscal health of the United States, which might seem counterintuitive for an emerging markets outlook. However, this serves as a useful barometer for how far the new US administration may go with tariffs and the geopolitical agenda. US government borrowing has soared, with US Treasury debt outstanding of $36 trillion, a six-fold increase since 2000; the US economy has grown three-fold in the same period, meaning that the US debt/GDP ratio is now approx. 120%. The cost of servicing this debt has also reached new highs at 20% of government revenues, a level not seen since the rebuilding period after World War II. Also, in the coming months, US lawmakers will be negotiating a new tax bill, which may encompass an increase in the debt limit. Were these fiscal efforts to fail, the US could increasingly use tariffs to make up any shortfall in targets or seek to extract a higher return from its roles in brokering international conflict resolutions.

Hard Currency Debt: Fed Cuts and High Yield Underpin Sentiment

Hard currency investment grade EM debt can benefit from Fed rate cuts and associated US Treasury yield declines. Spreads for IG are already at tight levels, so there is limited potential for them to narrow further from here. In a soft landing scenario, we would expect that spreads would not materially widen either, such that overall returns can be positive.

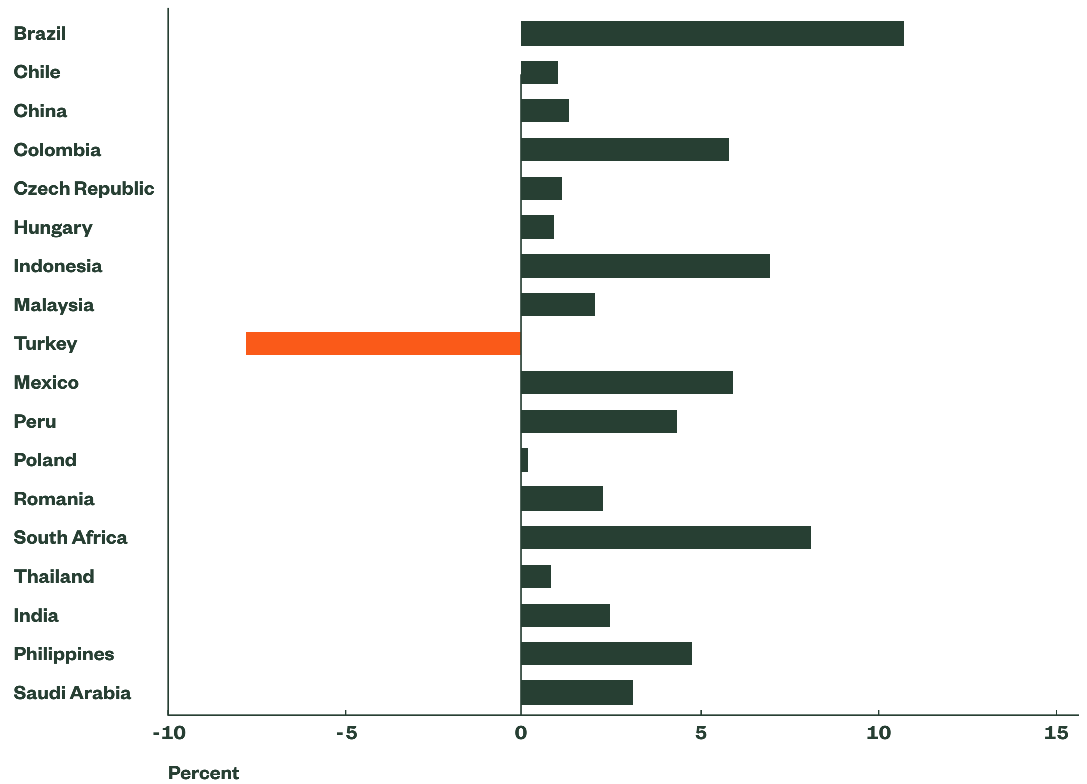
For the high yield segment, we believe that spreads offer some value given the many idiosyncratic situations that could have positive outcomes. However, not all countries are in the same position; in the absence of a catalyst, a softening of the US economy may not support spreads of these countries.

Local Currency Debt: EM Central Banks to Follow the Fed

Although inflation peaked in 2022 in most parts of the world, central banks adopted a cautious approach to cutting policy rates. Emerging economies, faced with domestic fiscal dynamics and currency headwinds, had particularly difficult decisions to make on the monetary policy front. Many EM central banks waited for the Fed to signal rate cuts before doing so themselves. We believe that a combination of rate cuts and a weaker USD is necessary to drive local currency debt returns.

There is still scope for EM central banks to cut further given that real rates remain largely positive (Figure 2). However, we believe that the timing and size of additional Fed cuts will continue to guide the path for EM central banks.

Figure 2
EM Real Yields Remain Positive



Source: State Street Global Advisors, Bloomberg Finance L.P., JP Morgan as of 28 February 2025. Past performance is not a reliable indicator of future performance.

For the FX component of local currency EM returns, a softening US dollar should enable EM FX — which is typically priced against the USD — to outperform. EM currencies remain significantly undervalued versus the US dollar.[2] While difficult to time currency moves, when EM currency valuations are this low the bond returns can feed through, with the potential for some currency appreciation as well. Historically, at this level of undervaluation, this has the potential to benefit dollar-based local currency investors over the long term.

The Bottom Line

Our outlook rests on the belief that US economic, geopolitical, and fiscal policy will support EMD assets through the rest of 2025, while recognizing that it will be transmitted differently across hard currency and local currency debt. Hard currency EM debt will benefit from a favourable US Treasury performance. Meanwhile, local currency debt will depend more on monetary policy at the country level; however, Fed rate cuts and a weaker US dollar can also drive performance in this asset class. The underlying dynamics and technicals are different for each segment, but US policy actions will set the agenda in 2025.

Of course, emerging market debt is not a homogenous bloc — it is a diverse collection of countries with different political systems, cultural norms, demographic trends, growth and trade dynamics, and economic levers. This year, more than ever, we are expecting heightened volatility and headline noise. For these reasons, we continue to believe that an indexed approach to investing in this dynamic asset class best harnesses the return potential in an efficient and transparent way.

Endnotes

1 Source: JP Morgan as of 31 December 2024.

2 We estimate an undervaluation of close to 12%, based on our FX models and using the currency weights of the JPM GBI-EM benchmark as of 28 February 2025.

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* Pensions & Investments Research Center, as of December 31, 2023.
† This figure is presented as of December 31, 2024 and includes ETF AUM of $1,577.74 billion USD of which approximately $82.19 billion USD in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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ID2733750-7767361.1.2.GBL.RTL 0325
Exp. Date: 31/03/2026