Emerging market debt outlook: Enduring strength

Insights
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2025 was a pivotal year for global financial markets, with emerging economies adapting to a significant shift in US policy and geopolitical uncertainty. Although US tariffs were a feature of the unfolding narrative, developed markets also contended with stubborn inflation, high US policy rates, and fiscal deficits. In contrast, EM countries have largely tamed domestic inflation while also delivering on growth. Given a largely benign macro landscape, and despite events in Venezuela in early January, we believe that emerging market debt (EMD) can build on the strong returns of the past year as investors adopt a less US-centric view of opportunities in the EM universe.

2025 in review: EM debt navigates shifting US policy

In the aftermath of Donald Trump's election, we anticipated that EMD prospects in 2025 would be heavily influenced by decision making in the US, rather than led by specific events in EM countries. This proved accurate as the Trump administration's actions, from tariffs to geopolitics, impacted sentiment and changed spending and inflation dynamics across the world. However, these effects proved to be short-lived as most participants readjusted to this new paradigm. Indeed, the impact of trade tariffs on most EM countries proved generally less severe than projected. One of the most significant factors for markets was the Fed's initial reluctance to cut rates amid inflation that stayed above target for a fifth year, highlighting divergent monetary policy paths between many EM and DM central banks.

While the Fed did pick up the pace of rate cuts in latter months, this was considered more as an "insurance policy" to stave off recession. The US dollar had already weakened ahead of the Fed's actions, while at the same time, the US Treasury curve steepened as investors demanded more yield to hold longer-dated US debt—this is a clear nod to broader concerns around the US economy and its fiscal trajectory.

EM countries had different experiences. Although the Fed's actions contributed to EMD hard currency performance, local currency returns were buoyed by EM rate cuts, robust growth, fiscal consolidation, and generally stronger currencies (reflecting USD weakness). It is worth noting that EM rate reductions amid easing inflation brought central banks back to a neutral stance rather than to an 'accommodative' position.

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EMD performance highlights[1]

- Hard currency EMD, as measured by the JPM EMBI Global Diversified Index, returned 14.3% (in USD terms) in 2025, driven by high yield sovereigns [+17.0%]. Countries with lower ratings such as Venezuela and Lebanon delivered significant gains amid political and geopolitical shifts.
- Investment grade (IG) sovereigns returned 10.0% on tighter spreads (of about 30 basis points) and a rally in duration. US Treasury 10-year yields, a reasonable proxy for EMD HC duration, dropped by 35bps.
- Local currency EMD, as measured by the JP Morgan GBI-EM Global Diversified Index, outperformed with a 19.3% USD return, bolstered by positive foreign exchange moves and real yields. This allowed EM central banks to ease monetary policy while being cognizant of economic growth needs.

Key Themes for 2026: constructive backdrop, cautious optimism

As discussed in our Global Market Outlook, the overall macro backdrop is favorable for fixed income globally, with three Fed rate cuts expected in 2026 amid decelerating economic growth. We retain a cautiously optimistic view, with a resilient US economy tempered by ongoing geopolitical tensions.

The environment continues to be constructive for local currency EM debt, with hard currency (HC) also expected to benefit from Fed rate cuts and anticipated returns from high yield sovereigns. EMD stands out for its attractive risk/reward profile, declining policy rates, and improving fundamentals has been reflected in credit rating upgrades. Against this backdrop, the strong recovery of primary market activity in 2025—even for high yield and frontier issuers—is likely to continue as investors target yield.

The Goldilocks scenario

A continuation of positive real yields, declining inflation, fiscal prudence, and currency tailwinds provide a set of circumstances that are 'just right' for **EM local currency debt**—the so-called Goldilocks scenario. Even as US growth slows and Fed rate cuts ensue, the consequent lower Treasury yields and weaker US dollar can act as tailwinds for EM returns. While valuations for higher quality issuers may appear stretched, many lower-rated countries are at the precipice of transformational change that could drive further rallies.

Local currency EMD prospects are not simply determined by the Fed's actions, as EM central bankers have built up credibility in delivering on policies that have supported their country's growth. Mexico, Poland, Indonesia, and many others cut rates considerably in 2025, and are likely to continue to do so, albeit at a slower pace.

Threats to this outlook

Although prospects for EMD are largely positive, there are risks.

An ever-present concern would be a shift in sentiment stemming from geopolitical or trade tensions. The recent actions in Venezuela by the US highlight how unpredictable the timing and outcomes can be, and this can weigh heavily on markets.

Another key concern would be if the softening US labor market sparked a downturn in consumer spending, something that could be exacerbated if tariffs keep inflation above target. In a "hard landing" scenario where US growth abruptly slows, this could weigh heavily on EM growth and their currencies versus the US dollar, impacting LC EM debt returns; for EM hard currency debt, this would weigh on spreads, although a concurrent drop in Treasury yield may somewhat insulate returns. The other tail risk is that the US economy overheats, keeping inflation above target and extending the Fed's bias for tight monetary conditions. In this scenario, dollar strength may become evident, and the Fed could even hike rates. Local currency EMD would not see an EM FX tailwind, but EM central banks would have more cover to cut rates if deemed necessary; meanwhile, hard currency EMD spreads may compress further, but these effects would likely be mitigated by rising Treasury yields.

Finally, elections are often catalysts for price movements. In 2026, there are presidential elections in Costa Rica, Colombia, Zambia, and Brazil, to name a few. But perhaps the most important one will be the November US midterm elections, which could tip the balance of influence in a tightly divided Congress and provide a good barometer of voter thinking ahead of the 2028 presidential election. Time and again, elections have shown a capacity to create uncertainty and volatility.

For **EM hard currency debt**, the investment grade portion of the asset class should also benefit from a decline in Treasury yields. Meanwhile, high yield could continue to see positive outcomes from possible country-specific events such as:

- Venezuela: Leadership change could accelerate a long-overdue debt restructuring
- Lebanon: A new government that could address its debt burden
- Argentina: Inflation decline could improve access to capital markets
- Senegal: Fiscal credibility could be restored with International Monetary Fund support
- Ukraine: An end to war with Russia would likely kickstart reconstruction

Enduring strength: EM central banks and policy credibility

Building on their enhanced reputation, central banks in emerging economies have successfully navigated a shifting global backdrop where US tariffs were rolled out, domestic and international political relationships were reset, and the geopolitics landscape evolved.

Risks from the US are fading

Tariff talk dominated the headlines for much of 2025. Our expectation that the high levies announced on 'Liberation Day' last April were a tactic proved accurate—tariffs were generally negotiated lower, or even reversed. With cost-of-living concerns a live issue in the US in a mid-term election year, the risks of new or higher tariffs upending global trade appear to have faded.

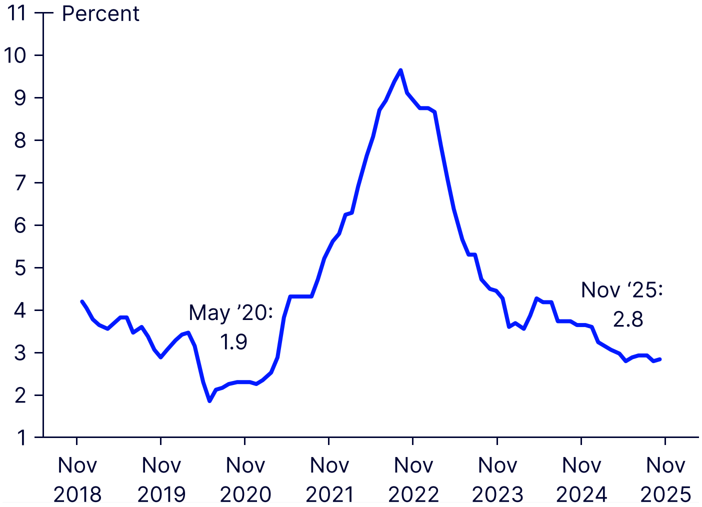
Geopolitics: Skewed to the upside

On the geopolitical front, the removal of President Maduro from Venezuela to a New York court marks a new development in US foreign policy—it is too early to see how this evolves but financial markets have been relatively calm. Elsewhere, the ceasefire agreed in Gaza has generally been holding, but progress has stalled on the more difficult task of a future vision; the role that Arab countries play in any resolution is key and the extent of their involvement remains unclear. Meanwhile, Russian demands for Ukraine concessions on territory has kept a ceasefire out of reach, although talks are ongoing. Europe has stepped up support for Ukraine to secure its borders, with the backing of the US. With these conflicts potentially nearing resolution, we believe risk is skewed to the upside for EMD.

A return to neutral rates

EM inflation has now returned to pre-pandemic levels, underscoring the success of policy measures. As a result, EM rates are now considered to be neutral.

Figure 1: EM inflation back at pre-covid levels

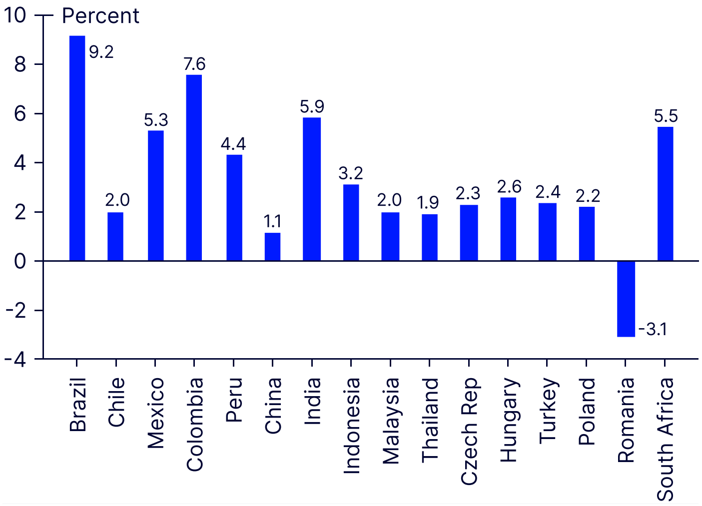


Source: Bloomberg Finance L.P, JP Morgan, as of December 31, 2025.

Attractive yields: All about the carry

Even after the gains achieved in 2025, there is still a strong rationale for EMD investment. Carry (the income earned for holding the bonds) is at the heart of return prospects in 2026. In **local currency EMD**, positive real yields indicate that valuations continue to be relatively attractive (Figure 2).

Figure 2: EM real yields remain positive



Source: State Street Global Advisors, Bloomberg Finance L.P., JP Morgan as of December 31, 2025. Past performance is not a reliable indicator of future performance.

Figure 3: Hard currency EMD yields (2021–2025)

Exposure	Yield to worst (%)						
	Dec 31, 2025	Dec 31, 2024	Dec 31, 2023	Dec 31, 2022	Dec 31, 2021	5-year average	Current yield's percentile (within 20-year range)
EMD HC (JPM EMBI GD Index)	6.80	7.86	7.84	8.55	5.27	7.27	68th
US HY (Bloomberg U.S. High Yield—2% Issuer Cap Index)	6.53	7.49	7.59	8.97	4.22	6.96	37th
Global Agg (Bloomberg Global Agg Index)	3.52	3.68	3.51	3.73	1.31	3.15	72nd

Source: Bloomberg Finance L.P., JP Morgan as of December 31, 2025. Past performance is not a reliable indicator of future performance.

On the **hard currency EMD** front, the relatively longer duration compared to other fixed income asset classes also presents relatively more attractive yields heading into 2026 (Figure 3).

Key drivers of EM returns in 2026

Hard currency debt: Fed cuts and high yield underpin sentiment

The narrative for hard currency investment grade EM debt remains consistent for 2026—it can benefit from Fed rate cuts and the associated US Treasury yield declines. Although IG spreads remain at record tight levels with limited potential to narrow further, we do not expect that spreads will materially widen from here, such that overall returns can be positive.

In the high yield segment, spreads may present relatively greater value given the many idiosyncratic situations that could drive positive outcomes. Indeed, countries like Venezuela, Argentina, and Lebanon are arguably on the cusp of transformational change, with potential upside for investors in their bonds. However, this is not true of all states—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 initially adopted a cautious approach to cutting policy rates. Many EM banks, faced with domestic fiscal dynamics and currency headwinds, embarked on a policy easing path even as the Fed dragged its heels on rate cuts. Although the pace of rate cuts is likely to decelerate, EM central banks have scope to cut further should it need to follow the Fed in 2026. That combination of rate cuts, central bank credibility, and a weaker USD, will continue to be key in driving local currency debt returns.

As FX is an important component of local currency EM returns, a continued downtrend in the US dollar should provide a tailwind—EM currencies remain undervalued versus the dollar.[2] While it is always difficult to time currency moves, when EM currency valuations are at these relatively low levels, EM bond returns can feed through, with any currency appreciation providing an added bonus. Historically, this level of FX undervaluation has often benefited USD-based investors in local currency EMD over the long term.

EM debt: Capture the upside in 2026

Emerging market countries are set to continue outperforming developed peers in policy execution and economic resilience. Although uncertainty in US policy and geopolitics persists, EM debt offers attractive opportunities, especially in local currency, supported by a weaker dollar, favorable yields, and policy normalization.

As the EMD universe encompasses a diverse spectrum of countries, each with their own political, economic, and cultural dynamics, we believe an indexed investment approach remains the most effective way to capture this diversity and harness the return potential efficiently and transparently.

Endnotes

1 Source: JP Morgan as of 31 December 2025.

2 We estimate an undervaluation of about 6%, based on our FX models and using the currency weights of the JPM GBI-EM benchmark as of December 31, 2025.

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* This figure is presented as of September 30, 2025 and includes ETF AUM of $1,848.02 billion USD of which approximately $144.95 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 Investment Management are affiliated. Please note all AUM is unaudited.

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