EMERGING MARKETS DEBT – MONTHLY MARKET MUSINGS

New year, new opportunities – more strong returns for EMs?

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Key takeaways

- After strong performance in 2025, we think emerging markets (EMs) are poised for another good year, supported by improved macro fundamentals, solid policymaking frameworks and more stable politics.
- With more easing from the US Federal Reserve and unconventional US policy, our outlook for a weaker US dollar implies a tailwind for EM local currency opportunities, which we continue to prefer.
- An update on technicals also shows a solid backdrop for EM: net sovereign issuance is likely to fall; the asset class remains under-allocated; and foreign inflows are coming back, including from China.

February 2026 – Emerging market (EM) fixed income had a fantastic run in 2025. The JP Morgan EMBIGD index for hard-currency sovereign bonds returned 14.3%, the equivalent local-currency index was up 19.3% and EM corporate bonds were up 8.7%. Investment flows returned to the asset class after a three-year hiatus. EM bonds overall attracted USD 31.2 billion in net inflows – a meaningful turnaround after USD 148 billion in outflows between 2022-2024. Inflows typically follow returns so the prospects for 2026 are bright.

We recently refreshed our EM fixed income outlook, arguing that conditions remain in place to deliver another strong year for the asset class. This is despite ongoing frictions in global trade, potential upside risks to US inflation and concerns around developed market fiscal sustainability and AI stock valuations. Geopolitics remain a factor to watch but – despite Greenland generating some market volatility – the market has tended to largely look past these issues in recent months. Overall, risks to the EM outlook remain largely exogenous – coming from outside the asset class. Many EMs enjoy improved macro fundamentals, solid policymaking frameworks and more stable politics. They have also enjoyed sovereign credit rating upgrades.

While the market learns more about the US Federal Reserve (Fed)'s new chair nominee, Kevin Warsh, and his views on interest rates, Fed independence and regulation, the most likely rate path still appears one of easing. A likely weaker dollar should then provide a tailwind, especially for EM local currencies. The US dollar has already fallen this year due to the criminal investigation of present Fed chair Jerome Powell, the Greenland controversy and suspected US-Japan currency intervention. President Donald Trump also said more weakening would be no bad thing. While the centrality of the dollar to the international financial system is unlikely to change, the "dollar debasement" narrative is gaining ground and the currency's status as a safe haven is in question.

Markets have sought other destinations for capital, and while precious metals have been key beneficiaries, EM currencies have also gained. Against the dollar, the Chilean peso, Brazilian real, Mexican peso, the Colombian Peso and South African rand are up between 3.5% and 5% this year. We continue to see opportunities in high yielding EM currencies as well as in bonds issued by the likes of Brazil, Peru, Romania and Turkey. Frontier market local currency opportunities are also gaining interest.

On the hard currency side, valuations tightened in 2025 but yields remain attractive. While the range of distressed credit opportunities has narrowed – only Senegal remains a potential candidate for default – the 80-odd countries that make up our investment universe still offer opportunities for good quality carry, eg, Benin, Colombia, Egypt and Pakistan. There have been no defaults in EM sovereigns in the last two years. We also think some of the reform stories of 2025 – Argentina, Ghana and Nigeria – may keep delivering across hard and local currency.

A solid technical picture for EM debt in 2026

We think 2026 presents a solid technical backdrop for EM debt. As we highlighted earlier, inflows returned to the asset class last year after a long pause. After USD 31.2 billion into the asset class in 2025, January has seen solid inflows too. EM fixed income has already received USD 7.5 billion in total, split across USD 1.2 billion in EM blended funds, USD 2.1 billion in EM hard currency funds and USD 4.2 billion in EM local currency funds – the latter being the sector with the highest returns last year. Since inflows typically lag returns, we think 2026 is likely to see more money being committed to the asset class.

The EM primary issuance market has also been bubbling with activity since the start of the year. EM sovereign supply has exceeded USD 70 billion – a record start of the year – driven by the European region and closely followed by Latin America. Concessions have been modest, order books on average 3.5 times oversubscribed and new issue performance has been strong. We expect more issuers to come to the market in the weeks to come, especially from frontier markets. Yet the supply picture looks favourable for EM sovereigns this year (fig. 1), with net issuance expected to drop by about a third from 2025. It will also be interesting to watch the split between US dollar financing and other currencies, after last year saw a shift into euro-denominated paper.

We have previously written about other supportive technical trends in EM – such as the growing role of local investors in their own markets, central banks' increasing appetite for diversification away from the US dollar, and institutional investors' chronic under-allocation to the asset class. We also looked at China's rising overseas investment flows into EM debt. Data for the first half of 2025 shows this trend continuing with a 38% increase year-on-year (fig. 2) – the second highest growth rate. Appetite is strong for high-grade credits in the Middle East but also in Central and Eastern Europe and central Asia.

Fig. 1 Primary issuance – EM sovereigns (%)

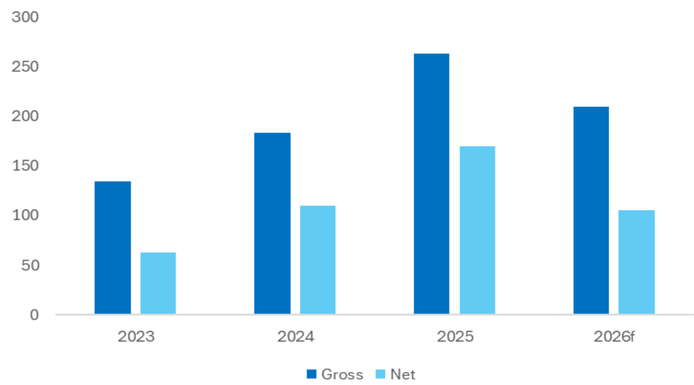
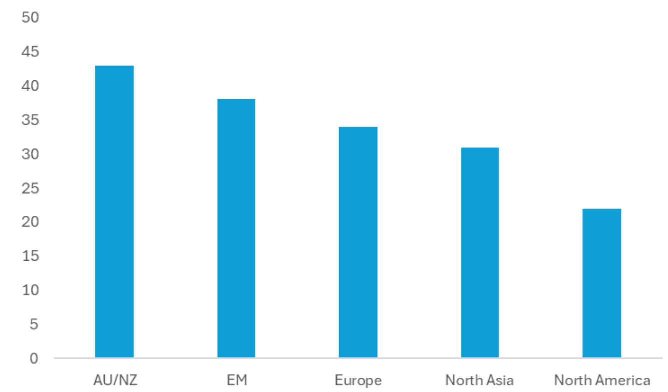


Fig. 2 Growth in Chinese bond allocations (% yoy)



With appealing yield differentials, a larger opportunity set of EM issuers, easing depreciation pressures in the renminbi and an apparent increase in Chinese households' appetite for financial market investments, as the local real estate market remains under pressure, investments from China into EM debt is likely to continue.

Investing involves risk. The value of an investment and the income from it may fall as well as rise and investors might not get back the full amount invested.

Past performance does not predict future returns. If the currency in which the past performance is displayed differs from the currency of the country in which the investor resides, then the investor should be aware that due to the exchange rate fluctuations the performance shown may be higher or lower if converted into the investor's local currency.

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