Emerging Markets Investor Diary

July 2025 | Diversification Opportunities in EM Local Currency Debt

The Case for a Structural Allocation to Emerging Markets Local Currency Debt

Executive Summary:

Author: Priyank Shah

- The breakdown in the long-held relationship between US assets and the US dollar signals a deterioration in its safe haven status. While the dollar's reserve currency status is unlikely to be seriously challenged in the foreseeable future, we see evidence of a rebalancing in global capital flows. As investors assess where to spend their marginal investment, we see the beginning of a shift in allocations away from US assets. Hedge ratios on USD assets have increased this year after decades of peak allocations benefiting from American exceptionalism.
- Emerging Markets Local Currency Debt is well positioned to capture this shift in global capital flows, following years of underinvestment by asset allocators and strong performance this year (greater than 10% YTD). Today, the asset class benefits from robust fundamentals, limited foreign investor participation, improved governance, light investor positioning and attractive valuations. Any demand shock from tariffs would lead to lower growth and inflation across EM, which enables policy rate cuts and positive returns from EM duration.
- EM real rates are at decade highs relative to DM, and a weaker dollar supports EM currencies, even as most EM central banks have built up credibility over time and several have moved to inflation-targeting frameworks.

Policy uncertainty can be a real disruptor. Back in 2018-19, proposed US tariffs on China was a challenge faced by an e-commerce company that sold ergonomic office accessories. One of their best-selling products directly impacted was a gas-spring monitor. When the US announced tariffs on Chinese imports, the company was caught in the crossfire–unsure whether to stockpile inventory, switch suppliers, or wait it out. By the time they acted, competitors with more agile supply chains had taken market share. That experience reinforces how policy uncertainty–not just the policy itself–can also be a real disruptor.

President Trump's rolling tariff announcements have only elevated policy uncertainty this year. They will be back into focus in the summer with more economic uncertainty with the Big Beautiful Bill. Despite the back-and-forth, tariff policy de-escalation has allowed risk assets to recover through the month of May, with a corresponding shift in the flavour of the dollar move, more DXY stability. Yet if the trade détente reverses, or if fiscal concerns and foreign taxes take centre stage, this is likely to shift again.

In this edition of the Investor Diary, we **argue a medium-term constructive case** for **an allocation to Emerging Markets Local Currency Debt**.

What happens when fiscal reality catches up with American exceptionalism?

Chart A: US yields and the Dollar

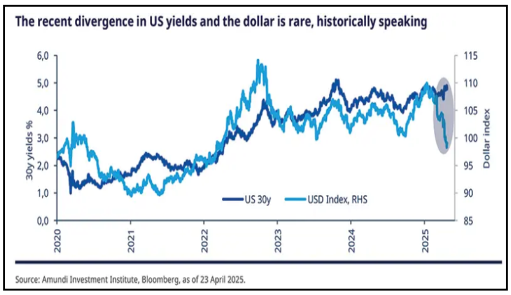


Chart A: Contrary to traditional dollar strength during risk-off episodes, this year the dollar has weakened, even as yields on 30-year US Treasury bonds have breached the 5% mark twice. The decoupling of the US dollar and US Treasury yields is a rare phenomenon, as highlighted by Amundi Institute. Typically, when market sentiment deteriorates, the net effect of higher US Treasury purchases relative to US Equity sales, should be positive for the US dollar, due to net inflows to the US capital account. A pursuit of policies that reduce the trade deficit would have the consequence of reducing its capital account surplus, leading to lower volumes of US dollar balances outside of the US being reinvested into US assets.

Chart B: Cross-Border Financial Flows

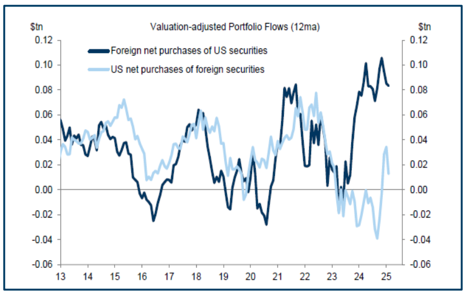


Chart B: Foreign holdings of US Treasuries have therefore reduced. Bond vigilantes have questioned US fiscal dynamics, marking US debt as more risky because of fiscal concerns and policy flip-flops on tariffs, contributing to a buyer's strike at the long-end of the US Treasury curve. Going forward, investors will pay keen attention to how global trade will be rerouted, the potential imposition of Section 899 (that gives the Treasury Secretary power to impose taxes on foreign holdings of US assets), the deficit-boosting fiscal programme and any pressure that might limit the Fed's latitude to make monetary policy decisions.

Chart C: Hedge Ratios

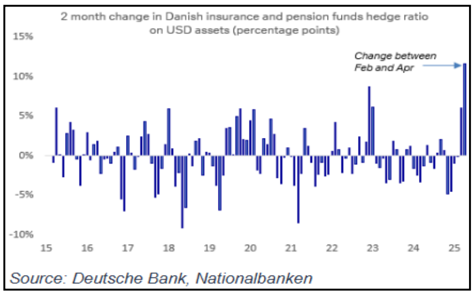


Chart C: After decades of peak US allocations, we see the potential for hedging ratios on US assets to increase. We notice how this process is already underway in places where managers have the flexibility to adjust them. The chart illustrates one such example: for Danish insurance and pension funds, the cumulative change between Feb and April was by far the sharpest two-month increase in hedge ratios over the past decade, as the recent phenomenon of USD weakness alongside higher yields and lower equity prices is a shift in the usual cross-asset correlations.

Therefore, in the current context, we conclude that additional incentives are now in place for global investors to look for alternatives for their marginal investment of dollar. Hedging ratios have increased with potential for going further, still led by aggressive diplomacy, an uncertain path ahead for tariffs and deteriorating US fiscal dynamics. We believe Emerging Markets Local Currency Debt is well positioned to capture this shift in global capital flows, following years of underinvestment by asset allocators.

In the next part of the diary, we turn our attention to the top five concerns for investing in Emerging Markets Local Currency Debt. Presented in a Q&A format, this section explores the key risks, macro sensitivities and structural questions that are shaping sentiment and allocation decisions in the opportunity rich space.

1. Has the US dollar sell-off run its course in 2025?

Following a ~10.5% correction from highs in early January, the dollar could rebound considering the mature market narrative around tariff and fiscal uncertainty. A reassertion of US exceptionalism via resilience in US data or announcements of trade deals could aid the rebound provisionally. That said:

- The US administration favours lower rates and a weaker dollar, as they aim to fix current macro imbalances
- Current trade policy discourages capital inflows to the US
- Business uncertainty remains high as the ultimate impact of tariffs has yet to be realised
- Even if tariffs are watered down, they represent stagflationary risks to the US economy
- On the other hand any growth boost from a fiscal thrust will likely be perceived by bond vigilantes as an imprudent fiscal path
- Lastly, valuations for the dollar have remained elevated for a considerable period of time

Therefore, we see near-term dollar rallies as selling opportunities, as we see a few factors that put in question a sustained dollar rebound.

2. Does pressure on the long-end of US Treasury curve lead to broad based pressure on Emerging Markets Local Currency Debt?

- We think not as EM are not in a full-blown fiscal crisis today. EM fiscal policy has been more prudent than DM's post pandemic, despite some challenges
- Yet fiscal risk in EM tends to be priced as local country specific risk, rather than global risk and there is a wide dispersion of fiscal positions across countries
- Fiscal balances in Brazil, Colombia, Hungary or Romania have undeniably deteriorated, yet there are relatively resilient examples such as India, Indonesia, Czech Republic and South Africa
- While higher than pre-pandemic levels, debt levels in EM are still lower compared to most other DM economies. Debt sustainability risks are limited to a handful of EMs

3. Why will Emerging Markets Local Currency Debt continue to perform well?

- Emerging Markets Local Currency Debt benefits from high carry, positive return potential from duration and alpha opportunities in EM currencies
- EM central banks have plenty of room to ease monetary policy considering their own domestic conditions against a backdrop of lower DM policy rates
- Returns on Local Currency bonds are supported by moderating growth and benign inflation
- Nominal and real yields (yields after inflation) remain high across several EM countries
- Taking three countries (Mexico, Brazil and South Africa) as examples: nominal yields range between 9-14%, while real yields range between 5-8%
- Finally, countries with a current account surplus are likely to see their currencies appreciate considering current US trade policies

4. Isn't the asset class riskier?

Chart D: Rolling 2-year annualised excess volatility (EM Local Currency Debt vs. US Bonds)

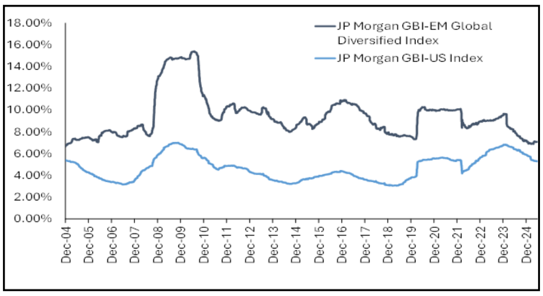
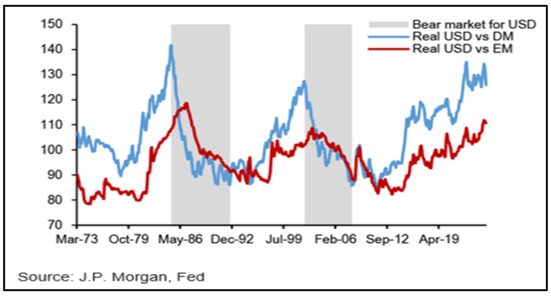


Chart E: EMFX valuations vs. USD at cycle peak



- As can be seen in Chart D, the excess volatility of the asset class has trended lower relative to previous decades
- Maturing institutions, improved policy credibility and higher economic growth have increased domestic investor participation in local markets, which has in turn helped reduce volatility
- The capping of exposure to large countries in the most widely tracked index (JP Morgan GBI-EM Global Diversified Index) further reduced index volatility vs. the previously popular EM (replicable) or Global (investible) versions of the index
- Chart E illustrates that the US dollar tends to move in long-term cycles. For instance: during the decade between 2002-2012 a decline in the broader US dollar aided Emerging Markets Local Currency Debt, while the subsequent rise in the last decade has dented returns, but valuations are now at cyclical peaks

5. What are the reasons to allocate today?

- Emerging Markets Local Currency Debt has shown remarkable resilience and outperformed all fixed income markets significantly this year (returning greater than 10% YTD)
- The asset class remains structurally under owned, with investor positioning at historically low levels reflecting a clean technical picture
- GDP growth differentials between EM and DM economies reflect a resilient and sustained EM growth premium
- EM inflation dynamics remain benign, enabling interest rates to fall further, with central banks that have room to cut policy rates
- EM fundamentals are improving: policy cycles are maturing, inflation is under control, fiscal risks are priced episodically, not structurally
- Nominal and real yields remain significantly high across several EM countries
- Current account deficits have broadly improved, lower oil prices are likely to improve terms of trade for several countries
- Structural improvements in governance with policy credibility and increasing participation of domestic investors
- A key beneficiary of capital reallocations led by America First policies
- A weak dollar cycle is well underway, even as EMFX fundamentals are relatively strong compared to history today
- The asset class is growing, with higher yielding countries such as Kazakhstan, Nigeria, Argentina and Egypt in radar to be added to the benchmark

Conclusion: A time to rethink allocation

We're at a crossroads. While the US still retains notable advantages, policy uncertainty and measures implemented to address current macro imbalances, are ikely to prompt investors to reassess their exposure. Meanwhile, **with robust fundamentals, cheap currencies** and **limited foreign investor participation**, several EM economies have been **reforming** and **maturing**. We believe this is not a trade — **it's a transition**. The longstanding assumption of EM as a unified investment construct erodes and flow dynamics hinge not just on broad asset class characteristics but also on country-specific exposure to global trade patterns and policy credibility. A **structural move lower in the dollar** may finally be underway. **That's a tailwind for EMFX allocations.**

A thoughtful allocation to EMD, especially local markets, is not just opportunistic. It's strategic. The kicker is if EM bonds can perform this well amid volatility, what might they do in a world of lower dollar, softer US growth and peaking rates!

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