

# EMD Q4: Will EMD outperformance continue in 2026?

**Jason DeVito, CFA**  
Senior Portfolio Manager,  
Emerging Markets Debt

**Mohammed Elmi, CFA**  
Senior Portfolio Manager,  
Emerging Markets Debt

EMD report Q4 2025

**Federated  
Hermes** 

Not FDIC Insured • May Lose Value • No Bank Guarantee

**Emerging market debt (EMD) is heading into 2026 bolstered by a supportive backdrop, underpinned by structural reforms and credible monetary policy at leading EM central banks.**

**Fast reading**

- EMD has delivered a strong performance in 2025, and we believe the backdrop looks supportive of further outperformance in 2026.
- Leading EM central banks are running orthodox monetary policy, which has helped anchor prices and set long-term inflation expectations.
- Select exposure to local currency bonds could prove to be a significant source of alpha in 2026.

Emerging market debt (EMD) has outpaced both developed market (DM) and broader fixed income gains in 2025. The asset class has benefited from shifts in the investment environment, which have set the stage for further opportunities.

Hard currency EM sovereign bonds have returned over 12% year to date, while EM local currency bonds have returned 15%<sup>1</sup> – and these returns have been balanced between both capital appreciation and income. We believe the momentum behind EMD looks likely to continue into 2025, as the asset class continues to benefit from a series of wide-ranging reforms that have reinforced stability in various domestic markets.

**12%**

Hard currency EM sovereign bonds return

**15%**

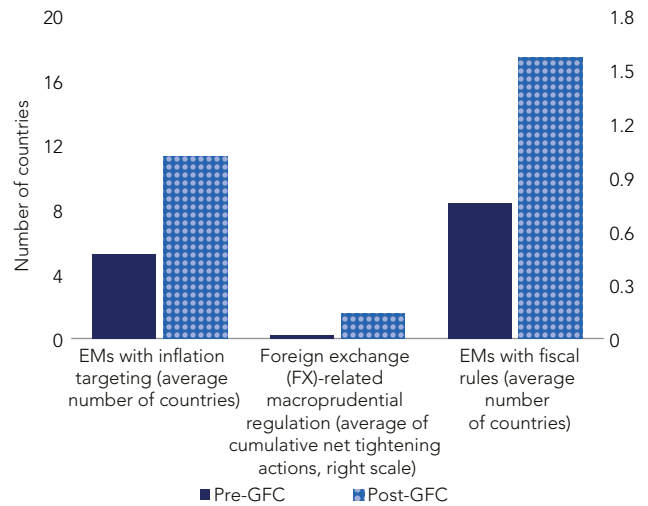
EM local currency bonds return

**Building the foundations**

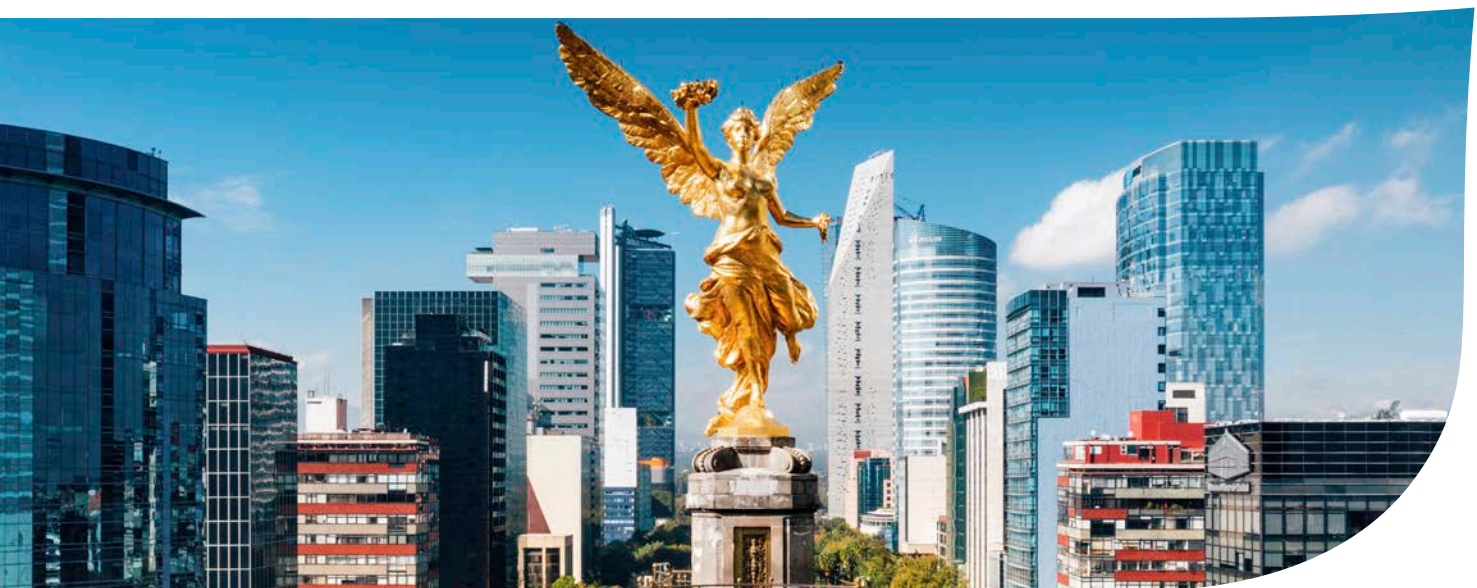
Emerging markets have historically been vulnerable to global financial shocks, such as the 2008-09 global financial crisis (GFC). However, EM authorities responded to the market meltdown by adopting inflation-targeting regimes and fiscal rules, as well as tightening macro-prudential regulations. These post-GFC reforms have played a crucial role in bringing greater macroeconomic stability in the wider EM region.

Figure 1 illustrates the extent of the reforms carried out in the wake of the GFC. The imposition of these frameworks served to enhance these markets’ ability to absorb external shocks and stabilise economic conditions. Stronger policy frameworks also helped enable access to IMF precautionary instruments, which are designed to meet the liquidity needs of member countries.

**Figure 1: The 2008-09 GFC spurred policy reforms across EMs**



Source: The International Monetary Fund (IMF). The pre-GFC period is 1997-2009, post-GFC period is 2010-24.



<sup>1</sup> Source: Bloomberg, as at 5 November 2025. J.P Morgan Emerging Bonds Index Global Diversified, J.P. Morgan Government Bond Index-Emerging Markets-Unhedged. Past performance is no guarantee of future results.

Figure 2 (below) shows how improved policy frameworks and fiscal discipline have helped boost the broader macroeconomic picture for EMs. J.P. Morgan Emerging Markets Bond Index (EMBI).

**Figure 2:** EMs boast stronger fundamentals across investment grade (IG) and high yield (HY) oil importers/exporters



Source: The International Monetary Fund (IMF) as of October 2025 including projections. Past performance is no guarantee of future results.

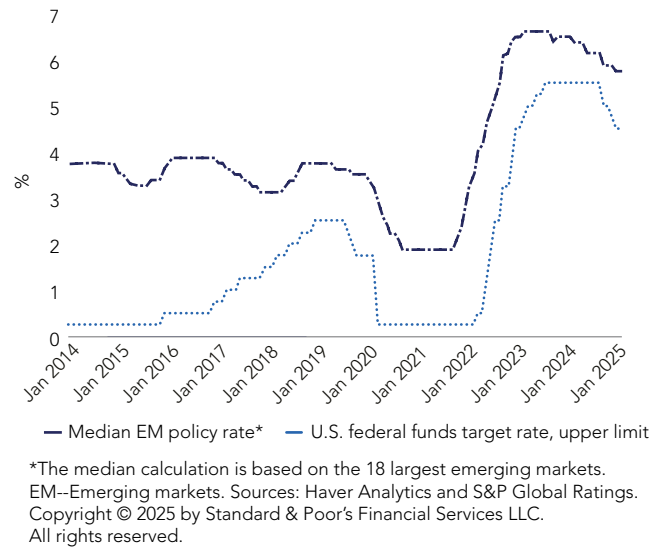


The Covid-19 crisis in 2020-21 put these frameworks to the test as the economic fallout from the pandemic was followed by a surge in global inflation.

While some, including former US Treasury Secretary Janet Yellen, believed this inflationary surge would be transitory<sup>2</sup>, many EM central banks took a more cautious approach and began hiking interest rates much earlier and at a faster pace than their DM counterparts (Figure 3).

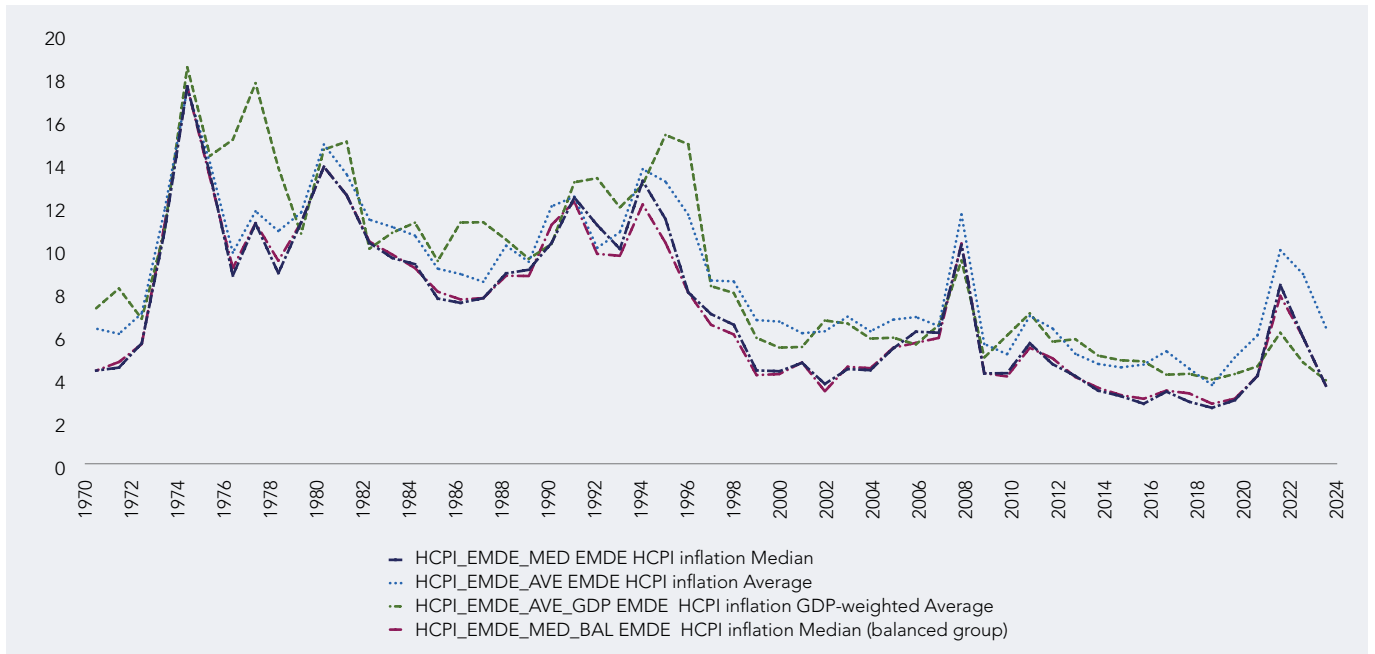


**Figure 3:** EMs moved quickly to head off pandemic inflation risk



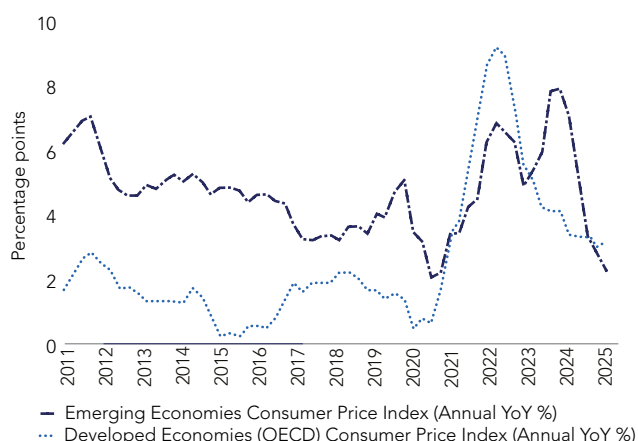
Leading EM central banks have prioritized credible, orthodox monetary policy to anchor prices and moderate long-term inflation expectations. Brazil, Mexico, and Chile, among others, began their tightening cycles in 2021, which has helped bring inflation under control faster than developed market counterparts (Figures 4 and 5).

**Figure 4:** EM inflation is coming down



Source: The World Bank. Version: April 2025

<sup>2</sup> Press Briefing by Press Secretary Jen Psaki and Secretary of the Treasury Janet Yellen, May 7, 2021 | The White House

**Figure 5:** Inflation trends invert

Source: Bloomberg as at 25 November 2025.

The moderation of domestic inflation means that EM central banks now have this additional capacity to stimulate economic growth through rate cuts, heading into 2026.

### Targeting local opportunities

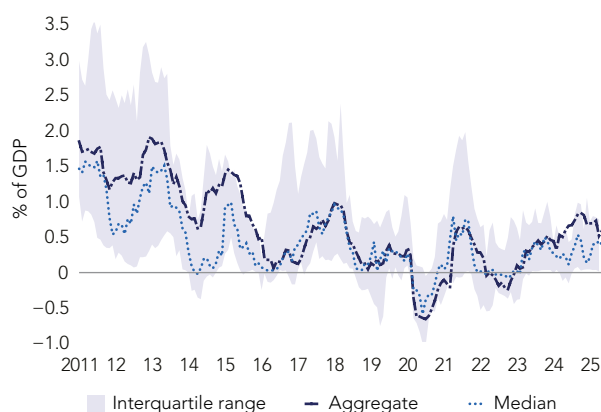
Another positive driver is the concerted effort to increase domestic ownership of local currency EM bonds – denominated in issuers domestic currencies – which have the knock-on benefit of making EM economies less dependent on foreign inflows and the instability that this can lead to during times of market stress.

The term the ‘Fragile Five’ was coined by Morgan Stanley in 2013 to describe five EM economies – Brazil, India, Indonesia, South Africa, and Turkey – that were perceived as particularly sensitive to capital outflows because they exhibited sizable current account deficits and leaned heavily on foreign investment. The so-called ‘taper tantrum’ in 2013 – market volatility sparked by the Fed tapering quantitative easing – had a significant impact on the five economies.

As a result, many EMs have sought to increase the role of resident buyers in their financing strategies. Sovereigns are no longer heavily reliant on external borrowing as domestic markets have expanded (see Figure 6).

Bangladesh, for example, identified local currency bond market development as a policy priority<sup>3</sup> and foundational reforms doubled the nominal stock of marketable bonds between 2019 and 2024. Georgia’s Ministry of Finance, meanwhile, launched a programme in 2020 which improved price discovery on benchmark bonds.

EMs with higher shares of local currency debt and more diverse investor bases have exhibited more stable bond yields and market liquidity during periods of global stress, according to IMF research.<sup>4</sup>

**Figure 6:** Foreign flows to local currency bonds markets have slowed

Source: The World Bank as at October 2025.

Local issuance remains strong even as foreign flows slow. EM-17’s corporate and sovereign issuance has reached US\$286bn in 2025,<sup>5</sup> exceeding the record-high level set in 2021.<sup>6</sup> As a consequence, these countries have seen their currencies appreciate by a median value of 4% year to date, while the median of real yields exceeds that of developed market counterparts by 330 basis points (bps).<sup>7</sup>

We are selectively increasing exposure to local currency bonds in response to this trend of EMs building out more robust domestic markets. We believe exposure in this area could prove to be a significant source of alpha in 2026.

<sup>3</sup> IMF Global Financial Stability Report, Chapter 2, October 2025

<sup>4</sup> IMF Global Financial Stability Report, Chapter 3, October 2025

<sup>5</sup> S&P Global. 30 September 2025.

<sup>6</sup> The EM-17 group includes 17 EMs, namely Argentina, Brazil, Chile, Colombia, Egypt, India, Indonesia, Malaysia, Mexico, Nigeria, Peru, the Philippines, Saudi Arabia, South Africa, Thailand, Turkiye, and Vietnam.

<sup>7</sup> Emerging Market Brief: Weak Dollar And High Real | S&P Global Ratings as of 9/30/25.

## Dollar weakness as a catalyst

A weaker US dollar and the resumption of the Federal Reserve's easing cycle have helped provide supportive financing conditions for EMs in 2025 and we expect this favourable backdrop will continue in 2026.

President Donald Trump has repeatedly expressed his desire for swifter and deeper cuts from the US central bank and has aimed a number of barbs at Fed Chair Jerome Powell. Powell's stint as chair ends in May 2026, leaving Trump the option to install a new chair who is more aligned with his priorities.

Meanwhile, US CPI has remained stubbornly above the central bank's 2% target, but it has spent the better part of the year contending with a choppy labour market. The Fed may have to prioritize stimulating economic growth over tackling inflation, which would point to further rate cuts. The weakness of the US dollar has already been a major theme in 2025 – it is down by around 8.2%<sup>8</sup> YTD – and more rate cuts are likely to put further downward pressure on the greenback.

A weaker US dollar, however, typically benefits EM issuers with a significant share of unhedged debt denominated in US dollars.

## Countries to watch

We see strong potential in several frontier markets. Disinflation is underway in **Nigeria** as a result of wide-ranging reforms, and the central bank has started to cut rates to support growth for the first time since the pandemic.

**Sri Lanka's** economic reform programme is positive for the country's long-term outlook and we are optimistic about its prospects. **Ecuador's** fiscal profile is improving, and the IMF has noted substantial progress on the implementation of their structural reform agenda, notably on fiscal, governance, and growth-enhancing areas.<sup>9</sup>

We are also positive on several countries supported by orthodox macroeconomic policies that have anchored spreads. **Turkey, South Africa** and **Brazil**, in our opinion, all offer a valuable income component on this front.

The economic rebound in **Argentina** remains a compelling story, particularly following the mid-term election result in October, which saw a landslide win for President Javier Milei's party. The Trump administration's US\$20bn support package should help to unlock further value. Meanwhile, **Columbia's** debt buyback strategy – part of efforts to cut borrowing costs – looks set to deliver a boost to the country's sovereign debt.

<sup>8</sup> US dollar index as at 27 November 2025

<sup>9</sup> IMF Reaches Staff-Level Agreement on the Third Review under Ecuador's Extended Fund Facility Arrangement



**Past performance is no guarantee of future results.**

Views are as of 11/25/25 and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Investments are subject to risks and fluctuate in value.

International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards.

Emerging markets are countries that are transitioning from the "developing" phase to the "developed" phase. Emerging market economies may be experiencing considerable economic growth and possesses some, but not all, characteristics of a developed economy. Key examples include China, India, Brazil, and South Africa.

Emerging Market Debt (EMD) refers to fixed-income (bond) investments issued by governments and corporations in developing economies. Emerging market debt may be investment grade or high yield, and issued in "hard currencies" such as the US dollar, or local currencies.

Prices of emerging-market and frontier-market securities can be significantly more volatile than the prices of securities in developed countries, and currency risk and political risks are accentuated in emerging markets.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Alpha measures the excess returns of a portfolio relative to the return of a benchmark index.

High yield, lower-rated securities generally entail greater market, credit/default and liquidity risks, and may be more volatile than investment-grade securities.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Credit ratings of A or better are considered to be high credit quality; credit ratings of BBB are good credit quality and the lowest category of investment grade; credit ratings BB and below are lower-rated securities ("junk bonds"); and credit ratings of CCC or below have high default risk.

**ICE U.S. Dollar Index (DXY)** measures the value of the US dollar against a basket of currencies of the top six trading partners of the US, as measured in 1973: the Euro zone, Japan, the United Kingdom, Canada, Sweden, and Switzerland.

**J.P. Morgan Emerging Markets Bond Index Global** tracks total returns for traded external debt instruments in the emerging markets.

**J.P. Morgan Government Bond Index-Emerging Markets-Unhedged Diversified** tracks local currency government bonds issued by emerging markets.

**MSCI Emerging Markets Currency Index** measures the total return of emerging market currencies relative to a base currency, typically the dollar, euro or Japanese yen. It reflects both currency appreciation/depreciation and interest earned on those currencies. The index weights each currency based on its corresponding country's weight in the MSCI Emerging Markets Index. CFA® is a trademark owned by the CFA Institute. Indexes are unmanaged and cannot be invested in directly. Current account balance is flows of goods, services, primary income and secondary income between residents and nonresidents of a given country. Quantitative easing is the process of a central bank purchasing government securities from the market in order to lower interest rates and increase money supply. Consumer Price Index (CPI) is a measure of inflation at the retail level. Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country. Forward-looking statements or projections are subject to certain risks and uncertainties. Actual results may differ from those expressed or implied.

52131 0019724 12/25

Federated Investment Management Company

FederatedHermes.com/us

© 2025 Federated Hermes, Inc.