The Emerging Markets "Beat" Goes On

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AUTHORS

DENIS COLE
Head of Portfolio Specialists

- Despite relentless market uncertainty, emerging markets debt (EMD) has produced strong outperformance since the end of 2023. With uncertainty likely to continue framing markets, we see a number of reasons for EMD to continue outperforming:
  - Global growth appears resilient and growth differentials are in EMs favor;
  - Improving EM fundamentals contrast a world of developed market deterioration;
  - A U.S. rate cutting cycle is likely to reduce tail-risks;
  - A weaker USD has multi-pronged benefits for EMs;
  - The macro environment supports carry—yields can generate strong returns;
  - And many of today's visible risks emanate from the U.S.
- This paper focuses on emerging markets' role in rescripting the New World Order amidst the pervasive geopolitical, global macro, and country specific challenges. Populist tendencies and polarized political economies are commonplace globally with market implications that are likely escalate in the fourth quarter and throughout 2026. If these implications materialize, the impact across countries would be varied, expanding the opportunities for alpha generation.
- Furthermore, as fiscal pressures across developed markets mount, the U.S. dollar has weakened despite interest-rate differentials moving in its favour. European assets have been the primary beneficiary of diversification from the U.S. assets YTD, but we believe the asset class offers an opportunity for investors to both diversify as well as outperform given the cyclical tailwinds and structural divergence in fundamentals that favour the EMD complex.

RESILIENT GLOBAL GROWTH AND EXPECTED EM GROWTH OUTPERFORMANCE

Despite lingering uncertainty around global trade, we are becoming more constructive around growth given the end-game for tariffs seems to be more benign than feared after the April 2 announcement. Our modal scenario for the macro environment is one of "muddling through," where the U.S. growth outlook remains clouded by government policies that could erode confidence in U.S. assets. These issues include U.S. fiscal sustainability risks and rising costs for U.S. consumers. We forecast that U.S. growth will remain well below trend in the 1-1.5% range through 2026.

A depreciating dollar and declining inflation should allow financial conditions to ease as strong balance of payments dynamics and a host of positive reform stories power EM growth to around 4%, highlighting the resilience of EM economies.

In **Europe**, we see economic growth gradually improving, but still low at 1-1.2%, underpinned by loosening fiscal policy, falling inflation, and higher real incomes, but still capped by weak sentiment due to ongoing trade and geopolitical uncertainty. As China deals with U.S. tariffs of 40-50%, we see growth softening in the second half as global demand moderates.

We believe **China** will likely grow in the 4-4.5% range this year and next, which indicates softer growth domestically, but a still meaningful contribution to global growth. We see China gradually easing off excess capacity with investment curbs in over-capacity sectors, while promoting investment in strategic sectors, including AI, and maintaining calibrated demand side stimulus to support the consumer, property sector, and infrastructure.

Emerging markets remain a global bright spot for growth over the medium term. A depreciating dollar and declining inflation should allow financial conditions to ease as strong balance of payments dynamics and a host of positive reform stories power EM growth to around 4%, highlighting the resilience of EM economies.

The quality of growth in EM is also improving at the margin: it is less credit-fuelled and more export and investment led. The continued strengthening of institutions is also visible as both central banks and finance ministries increasingly gravitate towards orthodox policies, evidenced by inflation-targeting frameworks, fiscal rules, and medium-term debt strategies—all of which are creating a more predictable policy mix and supporting the domestic environment.

There are outliers, not every EM is improving—some EMs are still running wide fiscal deficits, China's growth trend is clearly slowing, and geopolitics have kept fundamental dispersion high. However, the combination of tighter macro anchors, healthier external buffers, and better debt structures points to stronger EM sovereign resilience. Rating agencies have reflected this dynamic with a host of upgrades over the last few years, and, importantly, few sovereigns have been downgraded or put on negative watch.

The overall positive growth environment supports total returns within the sector. However, the large delta between developed market growth and emerging market growth should continue to drive EMD outperformance over its developed market peers (Figure 1).

Figure 1: Economic growth expectations

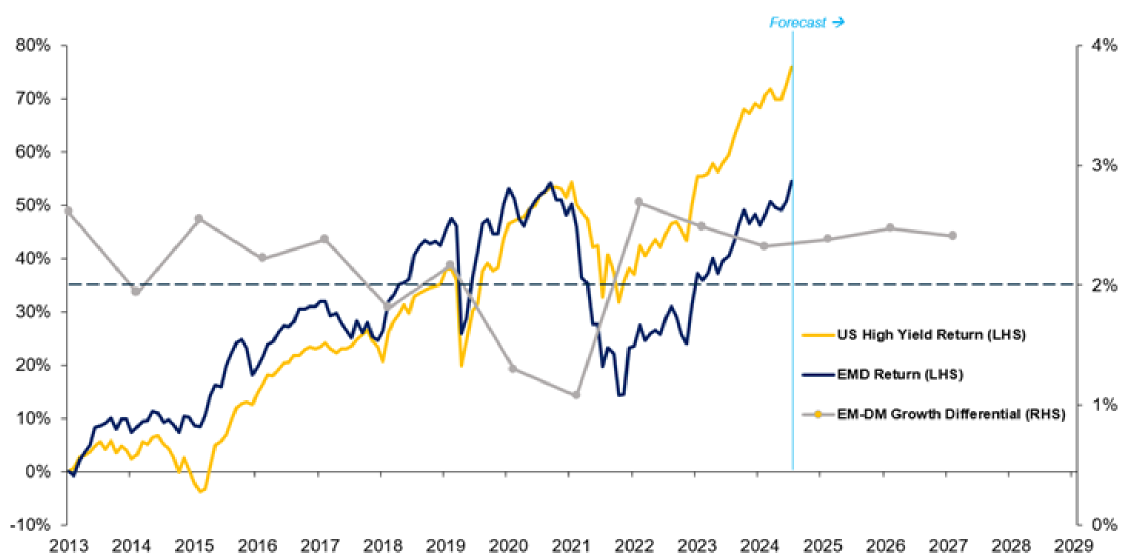
	2025		2026	
	PGIM Econ Team (%)	Market Consensus (%)	PGIM Econ Team (%)	Market Consensus (%)
Developed Markets	**1.3**	**1.4**	**1.3**	**1.4**
U.S.	1.3	1.7	1.4	1.7
EA	1.3	1.2	1.2	1.1
Emerging Markets	**3.9**	**4.2**	**4.0**	**4.0**
China	4.2	4.8	4.2	4.2
EM ex-China	3.7	3.8	3.9	3.9
EM-DM growth differential	**2.6**	**2.8**	**2.7**	**2.6**

Source: PGIM as of September 16, 2025.

When EM/DM growth differentials have been more than 2%, EMD has historically outperformed other developed market asset classes

The differential of emerging markets' growth relative to developed markets' growth has historically been the largest driver of EMD performance. When EM/DM growth differentials have been more than 2%, EMD has historically outperformed other developed market asset classes. Figure 2 compares EM-DM growth differentials with the cumulative performance of hard currency EM debt and U.S. high yield (other developed market credit indices could be replaced here to similar effect).

Figure 2: EMD and U.S. High Yield cumulative performance and EM-DM growth differential



Source: IMF, Bloomberg, PGIM Fixed Income

As expected, when that growth differential dipped below 1.5% in 2021 and 2022, EMD underperformed, and due to the severity of successive shocks post-COVID, the magnitude of EM underperformance was extreme. Even before the pandemic, there were signs that China's growth was decelerating as it faced challenges due to deleveraging, de-risking, rebalancing, and demographic shifts. However, the consensus view is for emerging markets to regain that growth premium going forward—well above that important 2% figure—and to remain above 2% for the foreseeable future, despite ongoing uncertainties around China's growth path.

FUNDAMENTAL DIVERGENCE: EM FUNDAMENTALS OFFER SHELTER FROM A DM STORM

Several factors have driven fundamental improvement within EM at a time when developed market fundamentals are deteriorating. EMs have benefitted from:

- **Stronger external balances** as current accounts benefit from higher commodity prices and better terms of trade. EM central banks have built strong buffers and meaningfully reduced external vulnerabilities.

- **Fiscal consolidation** post 2023. Finance ministries have reduced deficits by both reducing pandemic-era spending and improving tax collection.

More importantly, those that are running deficits have financing available and most have meaningful buffers that allow them plenty of time to adjust their budgets.

- **Debt management** exercises have increased meaningfully as many EMs have paid down debt, extended maturities, or diversified their funding mix using concessionary financing.

- **Monetary policy credibility** remains strong in EM after aggressive tightening cycles ahead of DM in 2021 and after central banks held rates in restrictive territory as inflation moderated. After a period where EM central banks were generally successful in bringing inflation under control, a weaker USD allows central banks to lower rates, which in turn will help growth.

- **Reform agendas** targeting taxes, pensions, and subsidies has improved fiscal situations as well as investor confidence and growth potential.

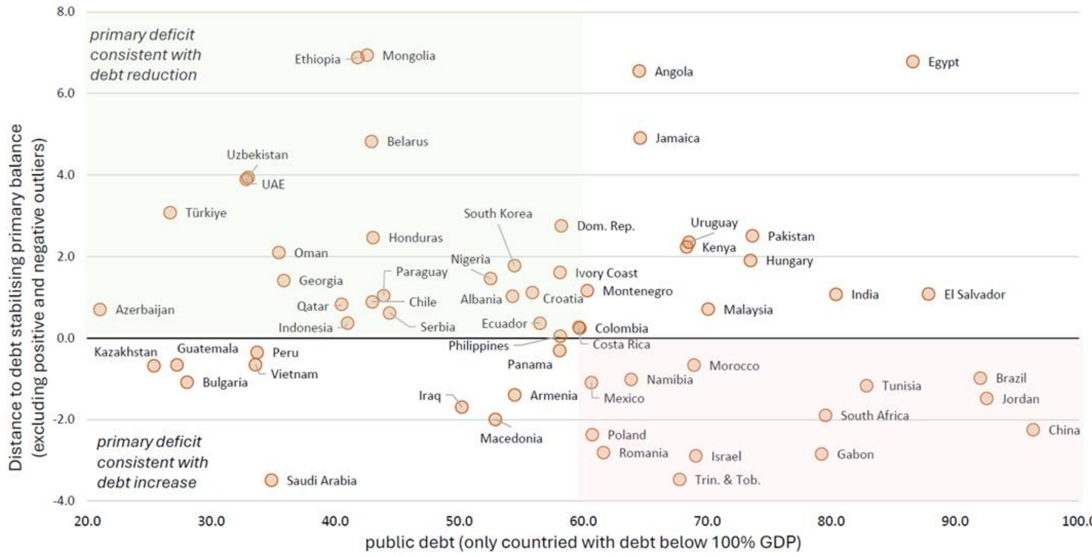
- **Improved financing options** as domestic debt markets mature, external debt markets have opened further, and concessionary financing remains available to issuers.

- **Foreign exchange** reserves have been replenished and offer meaningful buffers against shocks.

- **Local investors** continue to grow their own wealth and are investing in their own sovereign debt, both hard currency and local currency. Coupled with FDI, flows give the asset class staying power, even when external risks arise.

These factors have helped many EMs run primary balances consistent with debt reduction, particularly among the lower-quality EM sovereigns (Figure 3). More importantly, those that are running deficits have financing available and most have meaningful buffers that allow them plenty of time to adjust their budgets.

Figure 3: Public debt vs. distance to debt stabilising primary balance (% GDP)

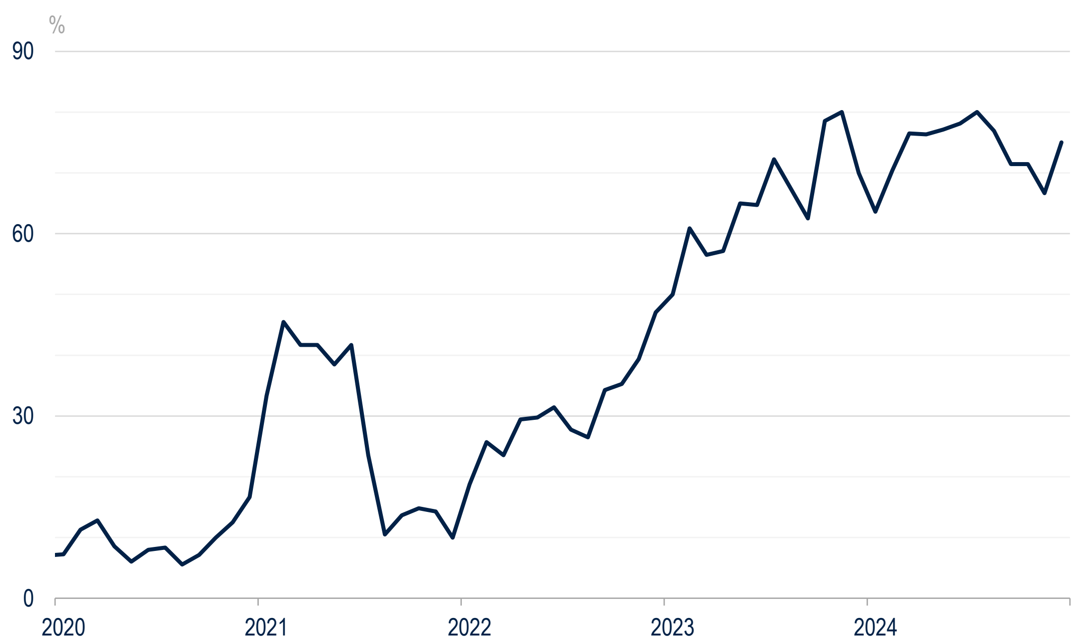


Source: IMF, World Bank, National Sources

We acknowledge that pressures for slippage could mount: fiscal and balance of payment dynamics are generally stable, but we have yet to observe the full impact of the U.S. tariff policy. As a result, we remain focused on resilient issuers and repricing stories. Political dynamics and election calendars (e.g., in Argentina, Brazil, Colombia) are examples of how the opportunity set needs to be examined from an upside/downside perspective to price in potential stress scenarios.

While we fully admit that ratings agencies are slow to react, they have noticed the improvement in EM fundamentals (Figure 4).

Figure 4: Sovereign rating upgrades as a percentage of rating actions



Source: Moody's Investors Service, S&P, and Fitch Ratings

A WEAK DOLLAR PRESENTS A HOST OF BENEFITS TO EMS

A weaker U.S. dollar has provided a tailwind to the sector in 2025 after a decade and a half of consistent dollar strength. Dollar weakness obviously strengthens EM currencies, but beyond that, it reduces EM debt metrics, lowers inflation, improves purchasing power, and reduces external pressures—all of which alleviates the pressure on EM central banks. Indeed, the moderating pressure has allowed EM central banks to ease financial conditions, providing a boost to the domestic growth outlooks in EMs.

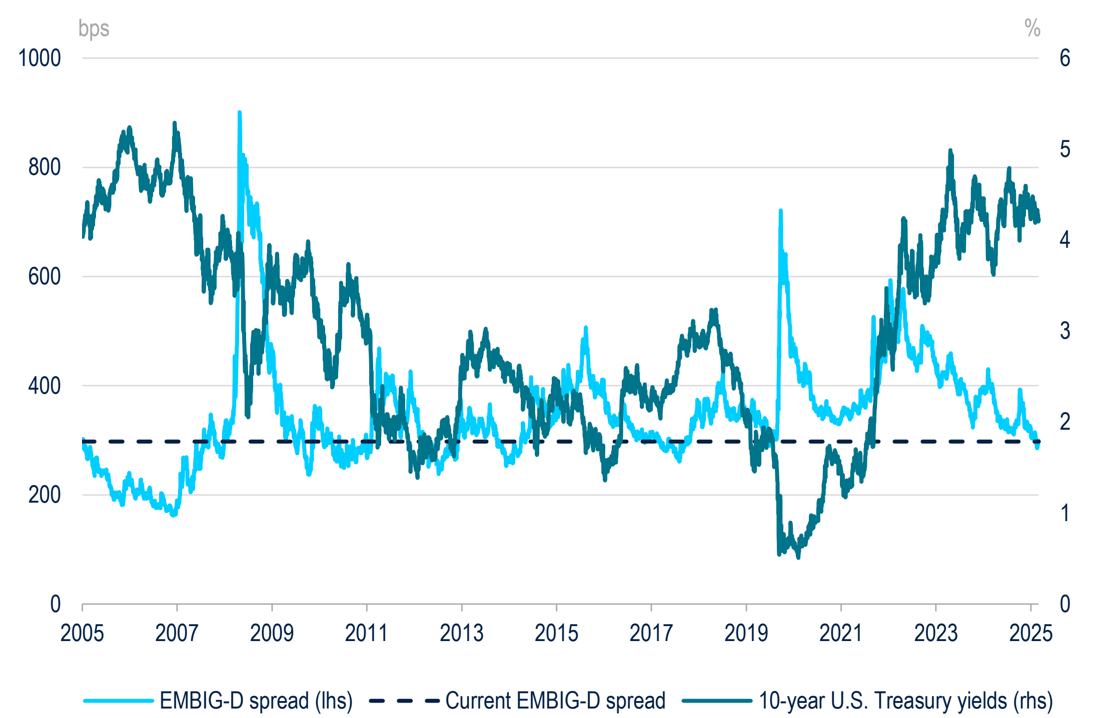
MARKET IMPLICATIONS:

EM SPREADS SHOULD REMAIN STABLE

While the macro backdrop remains highly uncertain, it appears to be supportive for fixed income, including EMD. All-in yields across fixed income remain high, despite spreads being near the tighter end of their range. EM spread standout for their relative value versus other fixed income sectors—indeed, spreads are not quite at their all-time or even post-GFC tights (Figure 5). While spreads are unquestionably at the tighter end of the range, the environment of historically high yields and stable economies adds context to that backdrop with the potential for further support for spreads.

Given the high all-in carry, the current coupon generation of the index produces a solid return on its own—with mild spread tightening/yield compression generating very attractive returns.

Figure 5: EM spreads and 10-year U.S. Treasury yields



Source: JPMorgan, Bloomberg, PGIM as of August 31, 2025

Given the supportive macro environment where growth does not contract and the Federal Reserve embarks on a rate cutting cycle, we expect spreads to skew to gradual, incremental tightening or a range bound trading environment. Given the high all-in carry, the current coupon generation of the index produces a solid return on its own—with mild spread tightening/yield compression generating very attractive returns. Additionally, the carry alone can offset almost 100 bps of spread widening without any move in core rates, so we expect total returns to skew

positively (Figure 6). In a negative global growth shock, rates should help drive performance in hard
currency assets. However, in a scenario where EM growth remains positive, carry should provide attractive returns alone.

Figure 6: 1-year hard currency expected return analysis

UST Yield Change (bps) \ Spread Change (bps)	125	100	75	50	25	0	-25	-50
50	-5.7%	-4.0%	-2.4%	-0.7%	1.0%	2.6%	4.3%	5.9%
25	-4.0%	-2.4%	-0.7%	1.0%	2.6%	4.3%	5.9%	7.6%
0	-2.4%	-0.7%	1.0%	2.6%	4.3%	5.9%	7.6%	9.2%
-25	-0.7%	1.0%	2.6%	4.3%	5.9%	7.6%	9.2%	10.9%
-50	1.0%	2.6%	4.3%	5.9%	7.6%	9.2%	10.9%	12.5%
-75	2.6%	4.3%	5.9%	7.6%	9.2%	10.9%	12.5%	14.2%
-100	4.3%	5.9%	7.6%	9.2%	10.9%	12.5%	14.2%	15.8%
-125	5.9%	7.6%	9.2%	10.9%	12.5%	14.2%	15.8%	17.5%

Overheating 9%
Mild Stagflation 9%
Muddle Through 48%
Productivity Boost 10%
Recession 15%

Source: PGIM

Headline fiscal deficits have narrowed on the back of reform agendas in many EMs, targeting taxation and subsidy reduction, helping reduce debt-to-GDP after the post-COVID spike.

Longer-term, yield-to-worst dynamics have been the best predictor to total returns. After yields rose in 2021 and 2022, higher yields have once again delivered higher returns (Figure 7). Importantly, yields remain high, likely serving as a preface to high total returns.

Figure 7: EMBI Global Diversified yield & return relationship

Period	Starting yield (%)	Annualized return (%)
2002—2012	11.3	11.2
2013—2022	4.3	1.6
2023—8/31/2025	8.5	9.9
8/31/2025 onward	7.3	?

Source: PGIM as of August 31, 2025.

As mentioned above, fundamentals are also supportive of spread levels as EM sovereign fundamentals have broadly improved as policymakers moved from pandemic-era stimulus to consolidation. Headline fiscal deficits have narrowed on the back of reform agendas in many EMs, targeting taxation and subsidy reduction, helping reduce debt-to-GDP after the post-COVID spike. During the rise in inflation, EM central banks tightened earlier and more aggressively than DMs, pushing real policy rates into positive territory and anchoring inflation expectations.

With disinflation now progressing, interest burdens look more manageable, and growth is more durable as central banks ease rates. External positions are sturdier too: current-account balances have normalized, FX reserve buffers have been rebuilt, and a higher share of local-currency funding reduces external vulnerability to any volatility in USD markets. Given a strong issuance calendar in 2025, many sovereigns have also smoothed amortization profiles, bolstered quasi-sovereign balance sheets, and used IMF or multilateral programs to lock in reform commitments.

Within EM corporates, fundamentals remain resilient, and we expect EM corporate high yield defaults to remain within the historical average of around 1.5-3%. The strength in EM currencies supports the ability of EM corporates to service their external debt more easily, and local financial conditions have opened more avenues for refinancing. The tariff risks have been mostly mitigated through realignment of supply chains, changes in product mix, and pre-emptive build-up of inventory. However, we are watchful of pressure on operating margins in the medium term.

LOCAL RATES CAN CONTINUE TO PERFORM

EM rates have had one of their best years on record as yield declined broadly. Following that performance, we are cautiously constructive on EM rates going forward. Under a stable to a weak USD and a dovish Fed scenario, investors should view EM local bonds as a pure yield play rather than a spread over core rates. That is why we prefer high yielding EM local markets over low yielders.

With U.S. terminal rates priced at 3%—unless the Federal Reserve accelerates the cutting cycle—it is hard for many low-yielding markets to outperform their current forward curves. But there are still attractive opportunities in many high-yielding curves, such as Mexico, Colombia, Brazil and South Africa. In Mexico, we believe Banxico has room to cut its policy rate to 6.5% versus 7% priced in the curve. In South Africa, we like the long end of the curve and expect issuance to come down in Q4. In Brazil, real rates are very high, and we expect the Central Bank to start the easing cycle as early as January of 2026. The front end of Colombia's curve offers an attractive roll and carry profile.

EM CURRENCIES SHOULD OUTPERFORM

U.S. exceptionalism drivers are waning. Fiscal impulse, immigration, tech-dominance have driven U.S. growth to be above trend for a number of years. Two of these drivers—fiscal impulse and immigration—have flattened or reversed. The weakening of these two drivers are partially driving the weakening of the U.S. labor market. The tech-dominance is still in effect as U.S. equities have outperformed other markets over the past several months, but importantly, more articles are being circulated that AI is starting to have a negative impact on the labor market, particularly within the 20 to 30-year age cohort.

The Federal Reserve restarted its cutting cycle to address concerns about the weakening labor market, which should keep USD upside, if any, capped. On top of the drivers of U.S. exceptionalism waning, confidence in U.S. policy making has lessened—from concerns over Fed independence to the Trump administration's unorthodox and capricious modus operandi. This also impacts sentiment towards the USD. An environment with no US recession, despite a weakening labor market, coupled with Fed cuts, is a constructive environment for high carry EM currencies in particular. Other factors supporting high-carry EM currencies include stimulus measures from China keeping stability in the economic backdrop which should keep volatility low.

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