EMERGING MARKETS DEBT – MONTHLY MARKET MUSINGS

Staying the (reform) course in a changing market backdrop

Giulia Pellegrini
Lead Portfolio Manager,
Emerging Market Debt

Key takeaways

- Emerging market (EM) performance has held up well against a volatile global market backdrop, with local currency bonds a highlight.
- This year, the main source of EM risk has been exogenous to the asset class. With US Treasury yields under pressure, could a sustained rise in the long end of the curve usher in a broad-based risk-off environment?
- While monitoring this risk, we think some of our key EM investment themes remain valid, with opportunities available in EM local currency bonds and selected EM countries on a reform path.

May 2025 – Over the last two months – from "Liberation Day" on 2 April to 27 May – emerging markets (EM) have been on a circular journey. At 331 basis points, EM sovereign hard currency spreads have tightened to where they were before US President Donald Trump's announcement of broad-based tariffs on virtually all his nation's trading partners. The main reversal came following news on 12 May of a temporary cut in tariffs between the US and China. This soothed market concerns over the impact of a trade war. Despite some lingering uncertainty on what will happen after the 90-day pause in US-China tariffs, fears of a US recession have abated, with most analysts expecting subdued but positive US growth this year.

This turn in the American economic outlook and market sentiment proved supportive for EM in the immediate aftermath of the tariff de-escalation news. The JP Morgan-EMBIGD index has delivered +1.9% year to date and the high yield (HY) segment +2.3% year to date. However, since then, market focus has shifted to the impact of the upcoming US tax and budget bills. While, on balance, lower taxes should boost US growth prospects, concerns are rising that the budget deficit would increase in coming years at a time when investor appetite for US assets is being tested across the globe. Nowhere are these concerns more clearly reflected than in the US Treasury curve, where 30-year yields have broken through 5%.

US interest rates have become the clearest expression of market sentiment. What investors are now considering is whether a sustained rise in long-end US Treasury yields could usher in a broad-based risk-off environment. As always, the speed and drivers of this move will determine whether other asset classes, including EM, can digest it.

As we monitor these developments, we are reminded that the main source of EM risk this year has been exogenous to the asset class. Yet while global risk considerations will continue to inform our portfolio positioning, we believe some key EM investment themes remain valid.

First, the impact of slower global growth is prompting EM central banks to consider more supportive monetary policy stances, albeit with an eye to currency moves and financial stability. We therefore think that, after an already impressive performance year-to-date (+9.5%), EM local currency bonds will continue to do well, with the ongoing rise in global bond yields testing investor appetite for dollar-denominated assets. While US Treasuries bore the brunt of the sell-off recently, the ensuing portfolio rebalancing efforts will likely bring about more US dollar weakness. Second, reform efforts in several EM countries are still on track, with the potential for further beneficial outcomes. Here, we highlight three idiosyncratic stories, informed by discussions we held at the Spring Meetings of the IMF and World Bank in Washington DC last month.

Argentina: lifting of capital controls

President Javier Milei's administration has pushed through deregulation laws and an impressive reduction in the deficit. Economic activity has held up, and inflation, while still elevated, has fallen. The IMF has granted a larger-than-expected front-loaded USD 20 billion package. Central bank reserves have risen thanks to agricultural exports and the lifting of capital controls for the first time since 2018 (fig. 1) – and the exchange rate has shown remarkable resilience. Despite the event risk of the October midterm elections, we think the reform momentum will be maintained, since recent local elections have seen strong approval for Milei's party.

Nigeria: fiscal reform is up next

Nigeria has been on a reform path since President Bola Tinubu took over in May 2023. Changes include removing the fuel subsidy, increasing oil production to near the OPEC quota of 1.5 million barrels per day (fig. 2), changing management at state oil company NNPC, liberalising the exchange rate to close the gap between the parallel and official rates, and revamping the local currency government bond market. These efforts have pushed net foreign exchange reserves to a multi-year high of USD 23 billion. Much remains to be done, including fiscal reform and bringing down inflation, which was 24% year-on-year in April. And pressure on oil prices is testing the authorities' fiscal plans, likely requiring some reprioritising of expenditure. But this would be another chance for Nigeria to show its commitment to reforms.

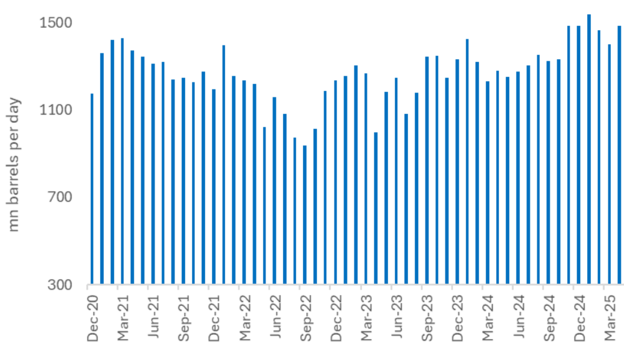
Pakistan: de-escalation supports reforms

After the exchange of blows over Kashmir, Pakistan and India agreed to a de-escalation. The skirmishes did not impact Pakistan's ability to service its external debt. The government remains committed to deliver reforms recommended by the IMF, which has released a second USD 1 billion tranche of financing. The IMF also cut its full-year 2025 fiscal deficit forecast for Pakistan to 5.6% of GDP, down from 6%, with the primary surplus growing to 2.1% of GDP, up from 1% in 2024. Remittances rose to a record high in March, helping the current account, which should also benefit from lower oil prices. However, profit repatriation keeps the balance of payments, and foreign exchange reserves, under pressure. Fitch's rating upgrade to B-, prompted by reforms, makes us believe more rating upgrades could be on the cards.

Fig. 1: Argentina's central bank reserves

Source: AllianzGI, Bloomberg.

Fig. 2: Nigeria's crude oil production



Source: AllianzGI, Bloomberg

May 2025