

Emerging Market Local Currency Bonds Deserve a Second Look

Improved resilience reflects a long period of macroeconomic and institutional reforms

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Improved resilience reflects a long period of macroeconomic and institutional reforms

Over the past decade, global stability has been anything but the norm. Instead, economies – both developed and emerging – have been exposed to a series of large-scale external risk events with far-reaching consequences. For example, US–China trade tensions during President Trump’s first term sent shockwaves through emerging economies, the unprecedented shutdowns caused by the COVID 19 pandemic stressed global economy and disrupted supply-chains, the weaponization of tariffs following Trump’s return to office has shaped global trade flows, and the wars in Ukraine and, more recently, Iran have triggered an energy supply crunch. Most likely the economic resilience of countries to face external shocks will continue to be tested in the coming years, given that global external imbalances have persisted or even increased, geopolitical risks are clearly elevated, international polarization has intensified, and the rules-based international order appears to be increasingly out of fashion. To put it differently, the list of potential triggers for global instability is long.

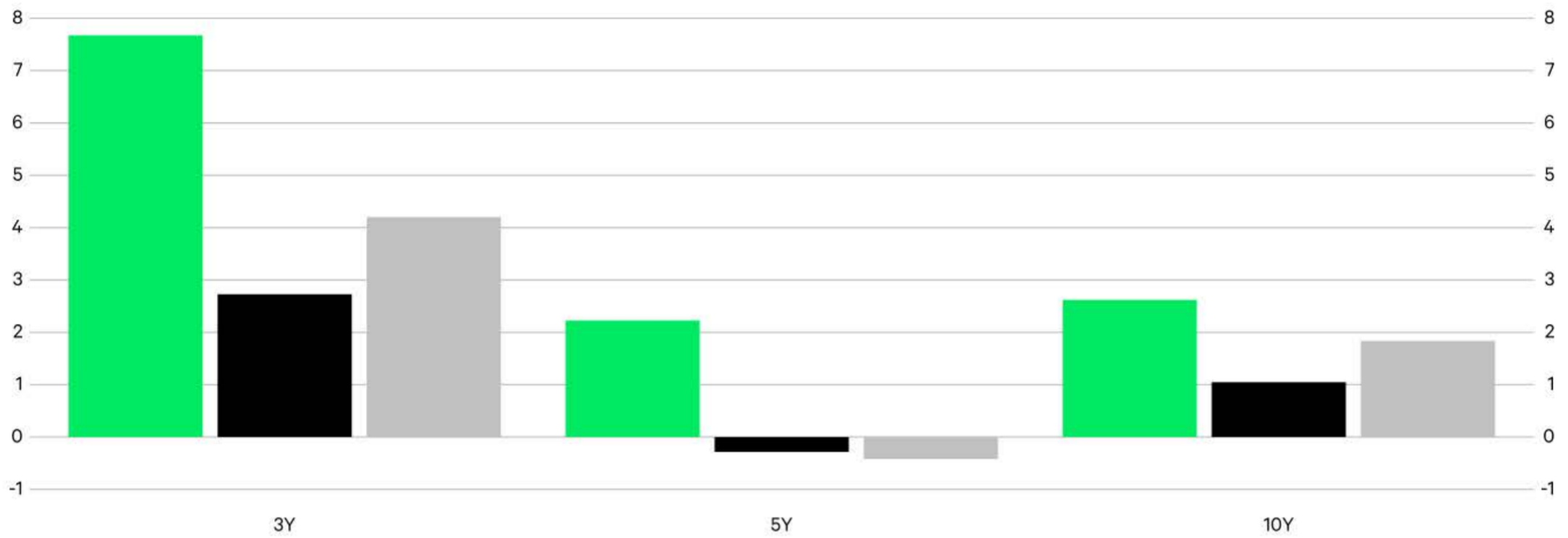
In emerging economies, rising external uncertainty has historically often triggered sudden stops: currency depreciation, debt crises, and sell-offs in local currency bonds. All of that might have had an adverse effect on economies, too. However, that hasn’t been the case in recent years. In fact, emerging economies have shown resilience against external shocks. Also, during the past few years emerging markets (EM) local currency bonds have delivered strong returns, and the relative currency volatility has been low by historical standards (charts 1 and 2).

Chart 1.

Government bond markets

Annualized total returns in USD (%)

■ EM local currency bonds ■ US government bonds ■ Euro area government bonds (USD hedged)



EM Local Currency bonds = J.P. Morgan GBI-EM Global Diversified Unhedged USD
 US government bonds = Bloomberg US Treasury Total Return Unhedged USD
 Euro Area government bonds = Bloomberg Euro Aggregate Treasury Total Return Index Value Hedged USD

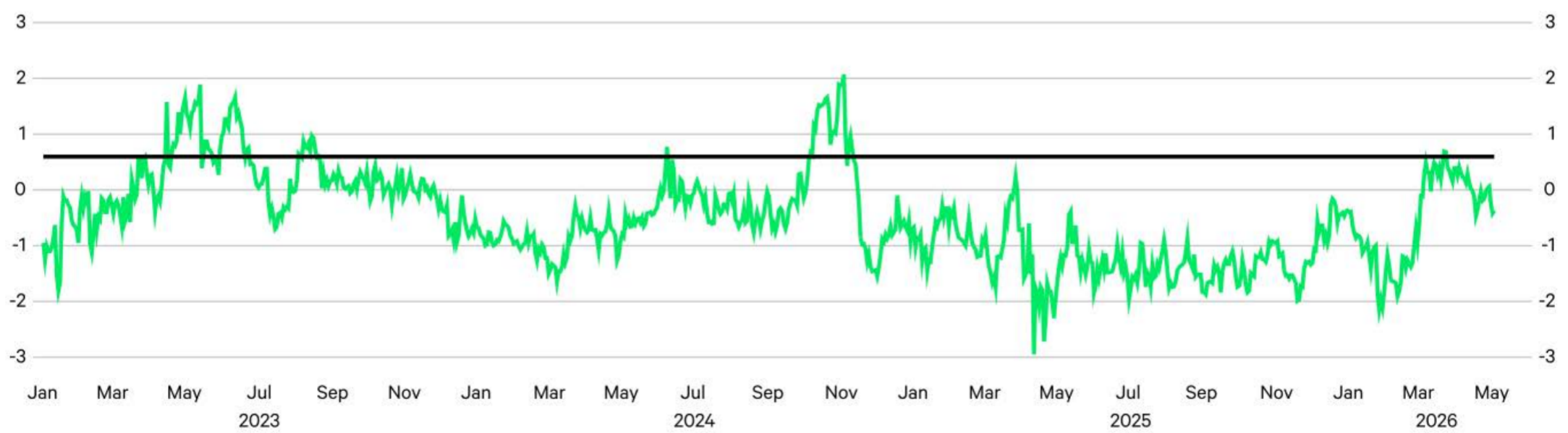
Source: Aktia and Macrobond

Chart 2.

EM FX volatility against the USD versus G10

%-points

— EMFX volatility less G10 volatility — 20Y mean for the volatility difference



EM FX volatility = JPMorgan EM FX Volatility 1M
 G10 FX volatility = JPMorgan G10 FX Volatility 1M

Source: Aktia and Macrobond

From Reforms to Resilience

Strong bond performance and the resilience of emerging economies can be partly explained by favourable external conditions. Decent and stable global growth, easier financial conditions, such as a long period of low interest rates and quantitative easing and relatively loose fiscal policy have kept the overall policy mix broadly accommodative. Since Liberation Day, dollar weakness has also played a role. Previously, during risk-off periods, the dollar tended to strengthen, reducing the attractiveness of EM local currency bonds for foreign investors. In April 2025, the dollar weakened amid a general risk-off episode when the Trump administration started to use tariffs as a foreign policy tool. Furthermore, when the war in Iran started, the dollar strengthened, but the move was not dramatic. Even though the dollar has not lost its importance as a global risk-pricing currency and safe haven, investors are searching for alternatives and diversification. These global conditions have played a significant role, but they are not the whole story.

Improved policy frameworks in EM economies have also mattered. Monetary policy implementation has strengthened, as during the past two decades or so, most central banks have adopted inflation targeting regimes. In addition, central banks have become more independent and credible, which has contributed to better-anchored inflation expectations. The results were visible during the post-pandemic inflation surge. On average, emerging market central banks responded more appropriately than their advanced-economy counterparts, resulting in a fast return to pre-pandemic levels. Additionally, their early action and clear communication helped them avoid the traditional negative effects of Fed tightening.

At the same time, foreign exchange policy has lost some of its importance, and EM currencies are now mostly freely floating. Using the exchange rate as a shock absorber for global shocks allows monetary policy to focus on domestic objectives such as inflation and growth. Furthermore, rapid adjustment in the currency helps to stabilise the current account and does not deplete reserves.

Another key element supporting freely floating currencies is the development of well-functioning domestic bond markets and a reduction in the reliance on foreign currency borrowing. As the domestic institutional investor base has broadened, in larger EM economies both governments and corporates can meet more of their financing needs in local currency, which also helps to absorb global shocks.

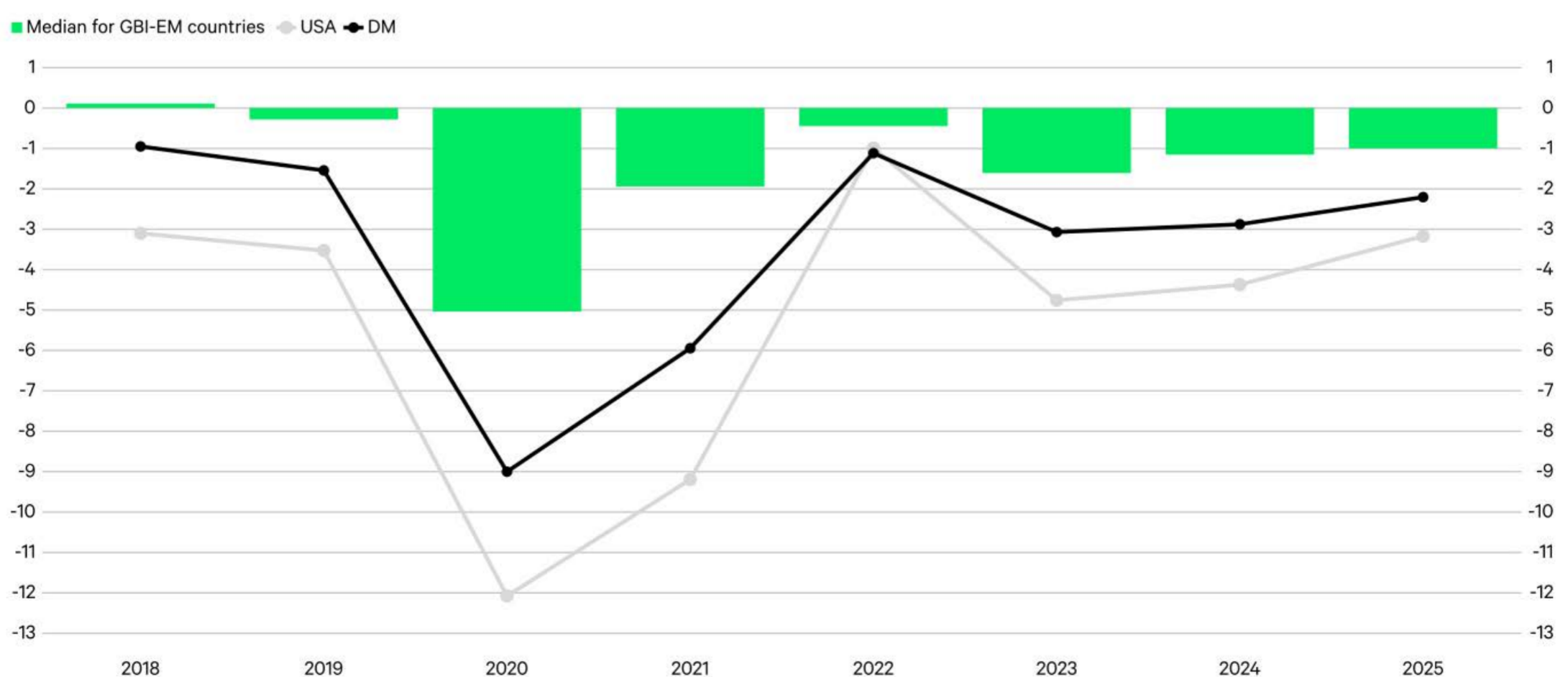
Foreign currency financing has become more opportunistic, and foreign-debt-related vulnerabilities have declined. Foreign debt exposure in emerging markets has fallen from 25% in 2007 to 15% in 2024, alongside lower borrowing costs. During the same period, foreign exchange reserves as a share of GDP increased from 13% to 18%, enabled by more flexible exchange rates.

Fiscal pressures have been a global phenomenon in recent years, and improved fiscal and economic policies have helped emerging economies as well. Debt levels have increased, and there is no major difference between advanced and emerging economies. However, on average, emerging economies have used less fiscal stimulus since the COVID-19 pandemic, and their primary balances have been tighter than in developed economies (chart 3). Furthermore, the adoption of rules-based fiscal frameworks has expanded alongside improved macroprudential policies. Fiscal discipline and strong fiscal institutions help attract both foreign direct investment and more R&D-intensive projects, and they have attracted foreign investors to local currency markets. With increasing fiscal pressures, global financial safety nets have also played an important role. EM economies have engaged with IMF facilities on a precautionary basis, helping to improve policy flexibility and market confidence. Since 2005, no major emerging market country has defaulted.

Chart 3.

General Government Primary Balance

% of GDP



Source: IMF, Aktia and Macrobond

Lost Decade to New Dawn

Seasoned investors remember the “Taper Tantrum” in 2013 and the “lost decade” in EM bonds. The emerging market growth story was closely tied to rapid growth in China and a commodity bull run, which was amplified by China’s stimulus to the infrastructure and real estate sectors after the Great Financial Crisis. In June 2013, the Fed reduced the amount of quantitative easing, which triggered a dramatic outflow from emerging market bonds, and many economies had to address their structural issues without easy money. Comparing the 2013 events to 2022, when the Fed delivered a significant monetary policy tightening, EM local currency markets showed remarkable resilience.

Indeed, the current situation differs markedly from those days. First, 13 years ago many countries were still building the institutional credibility they have today. Currently, inflation expectations are roughly one percentage point lower, reducing medium-term exchange rate pressure by a similar amount. Second, positioning was crowded at the time. For example, in Indonesia, Mexico, Poland and South Africa foreign ownership was close to 40% compared to the current shares between 14% and 28%. Third, valuations were challenging as emerging market currencies were, on average, about 10% overvalued, while bond term premia were, on average, tight. Currently pricing is more neutral and foreign ownership of emerging market local currency bonds is still low compared with the historical average.

Recently, heightened geopolitical uncertainty has underscored the importance of diversification. With a broad domestic investor base, domestic factors primarily determine EM local currency bond yields, making them less correlated with global risk sentiment and the dollar cycle. Countries with strong fundamentals, deep financial markets and tighter macroprudential stances tend to experience smaller currency depreciations and bond yield increases during risk-off periods. We have witnessed this in recent crises, where spillovers have been negligible. Additionally, in a global asset class, regional crises can leave most of a portfolio unaffected, and local politics rarely have global effects. With more diversified economic structures, larger emerging economies are less driven by oil or commodity price moves, although these factors still matter. A global portfolio has shown its strength in recent years.

Navigating Risks

There is still a lot to do in most EM economies, as only a handful of countries have risen to, or are very close to, developed economies such as the Czech Republic, South Korea, and Singapore. Even though domestic funding has reduced the need for foreign borrowing and the currency risk on economies' balance sheets (i.e., revenues in local currency and financing costs in hard currencies), selling local currency bonds to foreign investors transfers the currency risk to them, which may add volatility to portfolio flows. Furthermore, the increasing role of non-bank financial intermediaries, funds, and especially ETFs, may add volatility.

EM economies are a heterogeneous group in many ways. Less developed economies still need to rely more on foreign financing, and debt levels are increasing. Some emerging countries (Brazil, India) already have debt levels similar to developed countries. With increasing government debt, central bank independence is under stress in many countries. A recent example is Colombia, where the government tried to prevent a rate hike. Developed countries are not necessarily any better on this front.

Conclusion

Currently, valuations are close to all-time highs in many risky asset classes. Equity valuations are elevated, especially in U.S. equities, while corporate spreads are near their lowest levels. Emerging market local currency bonds are not cheap, but relative to other risky assets, there are still pockets of value.

Real rates are still historically high (chart 4), providing decent carry compared with euro or dollar risk-free rates. After the war in Iran, local currency bonds' term premia are still elevated due to heightened global uncertainty (chart 5). For foreign investors, emerging market local currency bond returns are mostly driven by currency performance. Historically narrow inflation differentials, together with prudent monetary policy, may keep weakening pressure manageable. Even though FX volatility has risen somewhat, it is still below its long-term average. On a real effective exchange rate basis, valuations are still not particularly challenging.

Chart 4.

Real ex-post 5Y rates (%)

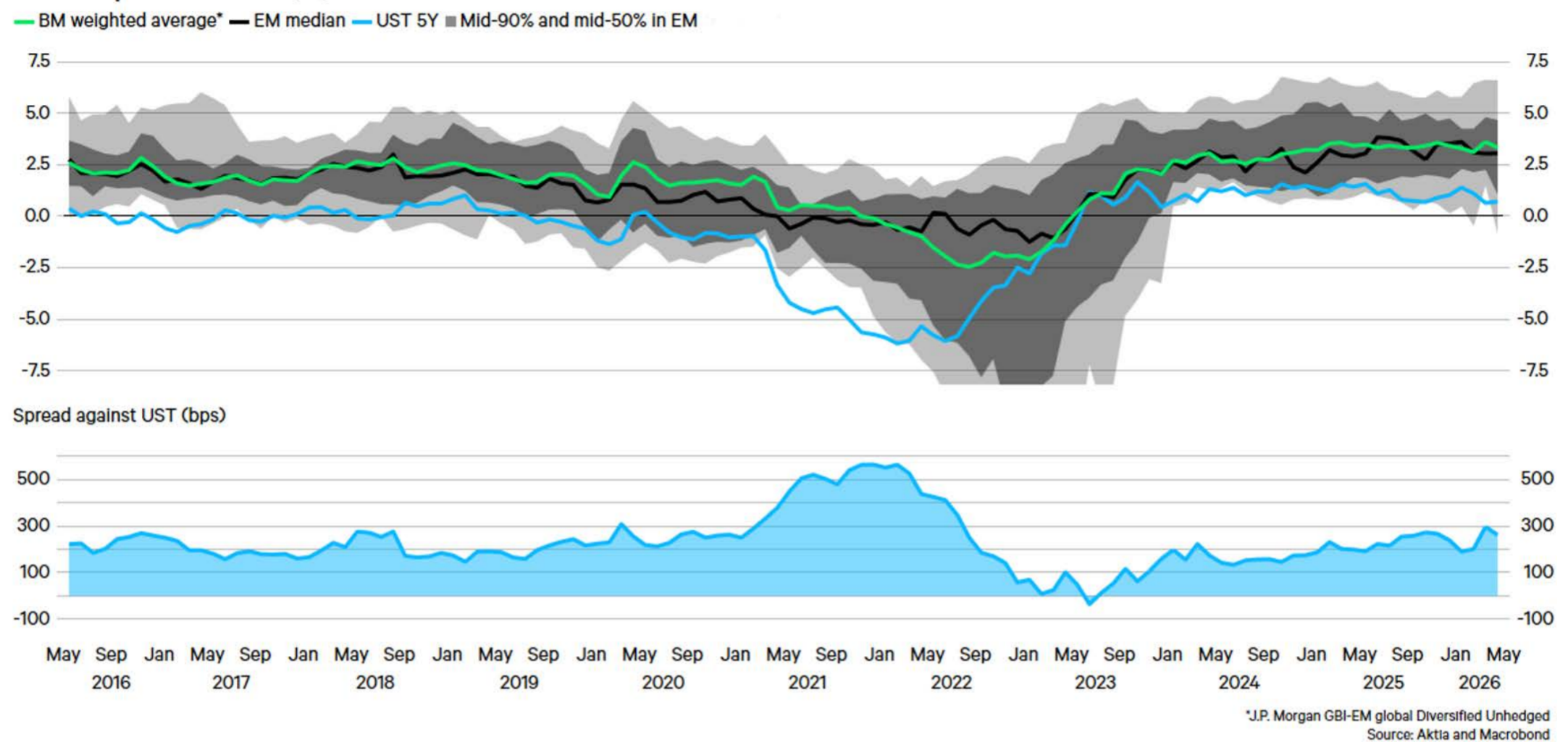
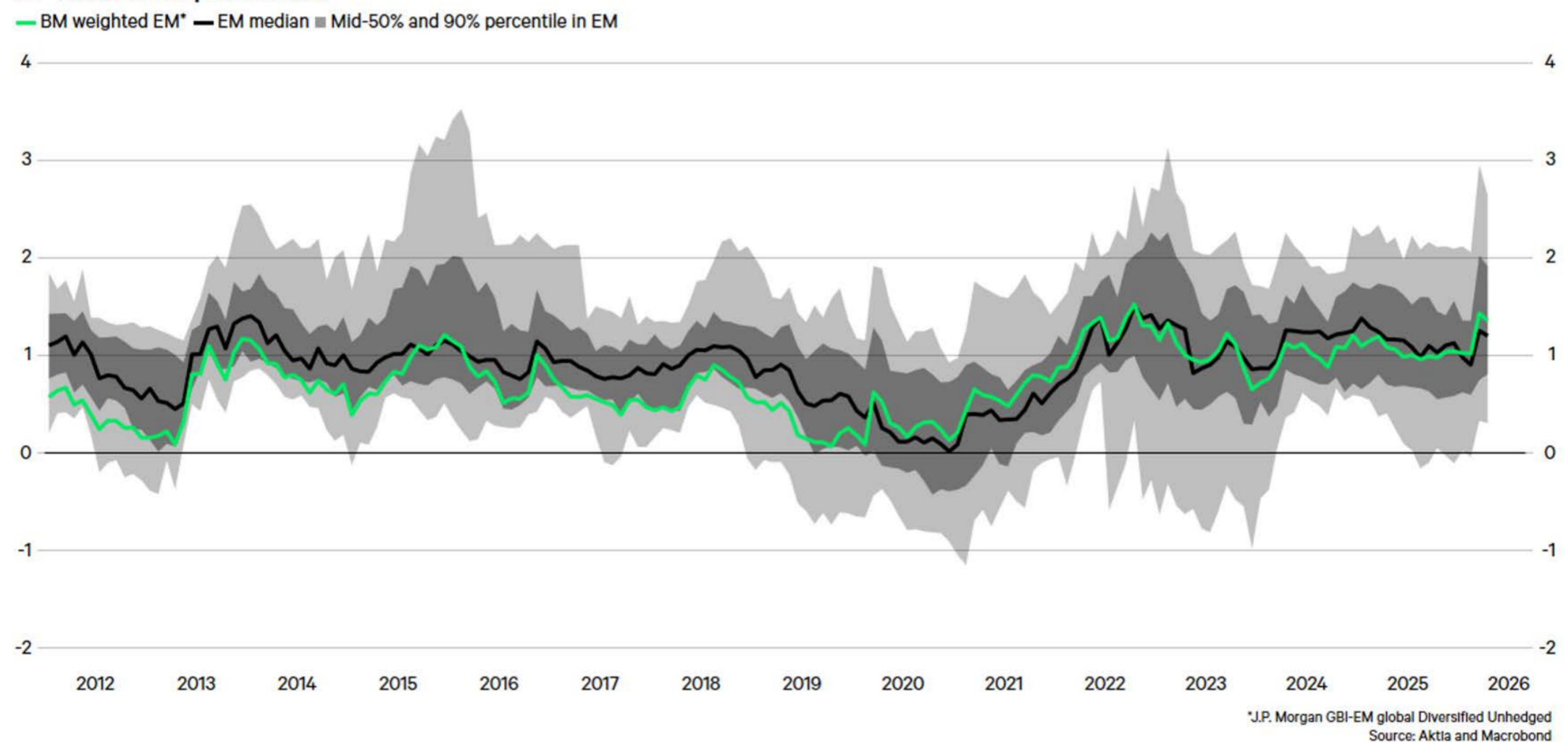


Chart 5.

5Y bond term premia (%)



Recent shocks have shown that emerging markets that have strengthened their policy frameworks are better able to absorb shocks and have better market access. Concurrently, sustained progress is still needed in many countries to improve domestic policy credibility and macroeconomic stability. For an active portfolio manager, this opens pockets of alpha.



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