Central Banks & Emerging Markets Debt: The case for emerging market investment grade sovereign hard currency debt

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The framework for managing reserves by central banks has generally focused on achieving three core objectives: capital protection, liquidity and return. Optimizing along these parameters inevitably involves trade-offs.

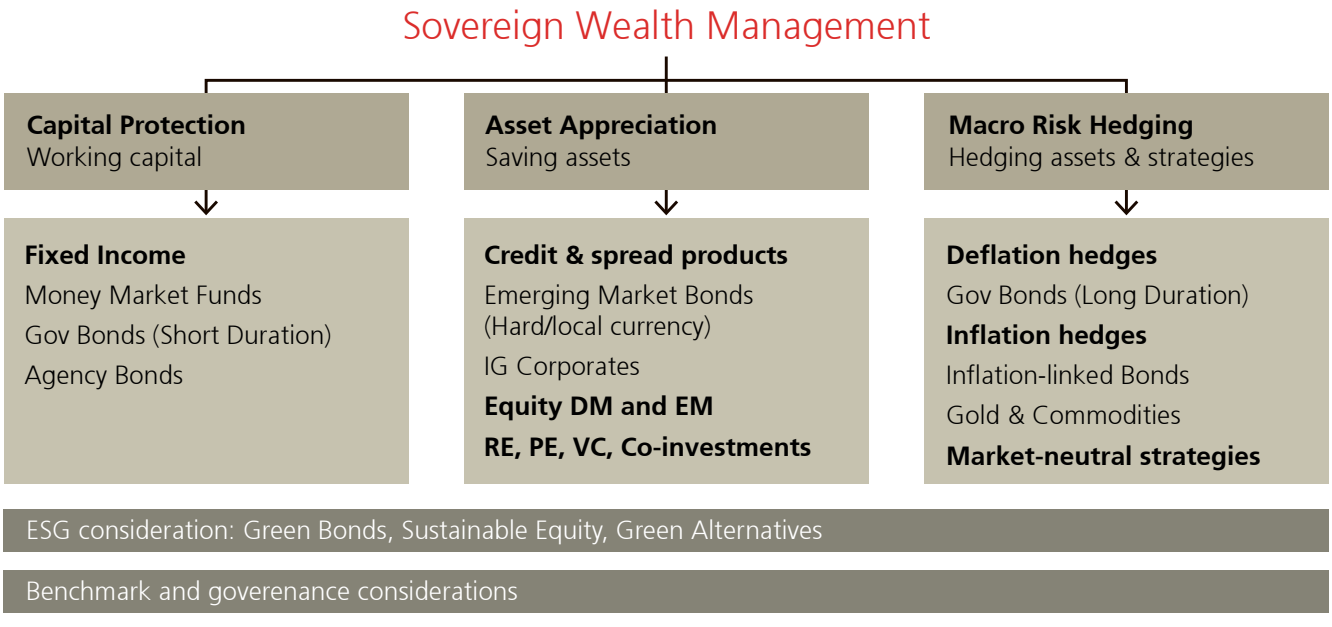
Traditionally, capital protection and liquidity have been the two foremost objectives with risk-adjusted returns ranking lower. The era of ultra-low interest rates and subdued volatility that prevailed after the Global Financial Crisis prompted reserve managers to broaden their investable universe to generate higher returns and protect capital in real terms (see Figure 1). Many diversified away from fixed income into listed equity to take advantage of low volatility and negative correlations with government bonds.

However, we are now entering a new regime that will be marked by dispersion across global interest rates, unpredictable business cycles and volatile stock-bond correlations.

This shift will require a rethink of prevailing asset allocation and diversification concepts within central banks. Fixed income is likely to play a crucial role, not only in terms of capital protection, but also as a source of income.

Emerging market (EM) investment grade sovereign debt in hard currency is an asset class that can potentially strike a balance between the different constraints central banks are subject to, while also making a significant contribution to protecting their reserves in real terms.

Figure 1: Framework for managing central bank reserves: Towards a new paradigm



Source: UBS Asset Management, Q1 2025

Asset class outlook

The shift from the lower-for-longer regime that prevailed since the early 2010s to higher-for-longer following the COVID crisis has led to a dramatic increase in the expected returns of fixed income assets. Given its traditionally low volatility when compared to listed equity, fixed income assets have become relatively much more attractive in risk-adjusted terms. This provides reserve managers with an excellent opportunity to potentially generate adequate returns relative to previous investment regimes. High valuations in listed equity markets, particularly in the US, is also a growing concern among central banks that diversified into this asset classes during the low-yield years.

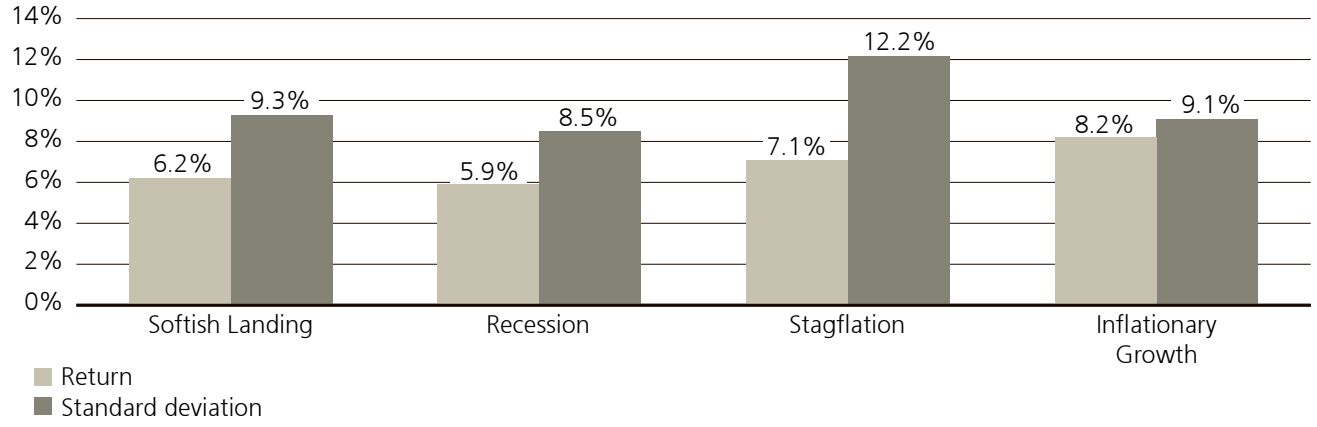
For instance, a short-duration global government bond portfolio resembling the composition of global FX reserves – largely USD, plus euro, sterling and yen – is expected to generate a return of around 4% in the next five years, according to our estimates. Between 2009 – 2021, the same portfolio generated a return of less than 1%. Higher returns are also expected for spread assets. An investment grade corporate bond portfolio is expected to generate a return of around 4.5% over the next five years, more than 3% higher than in 2020.

Emerging market debt (EMD) in hard currency is also expected to generate robust returns. Our estimates suggest this asset class could generate a return of over high-single digits in a softish landing scenario. This expected return is close to that of listed equity, but with a much lower levels of volatility.

Higher return expectations for emerging market debt also hold up across more pessimistic scenarios. The table below outlines the expected 5-year returns for hard currency sovereign emerging market debt which includes investment grade and high yield countries under a number of different economic scenarios. The results show that even in relatively downbeat recession and stagflation scenarios, nominal 5-year returns are expected to be relatively high compared with historical returns.

For reserve managers, hard currency emerging market debt could partly replace the return enhancement role played by listed equity with the potential advantage of lower volatility.

Figure 2: EMD expected returns and volatility across alternative scenarios



Source: UBS Asset Management, Q1 2025
Expected EMD returns calculated using the JPMorgan EMBI Global Diversified Index

Robust risk-adjusted returns

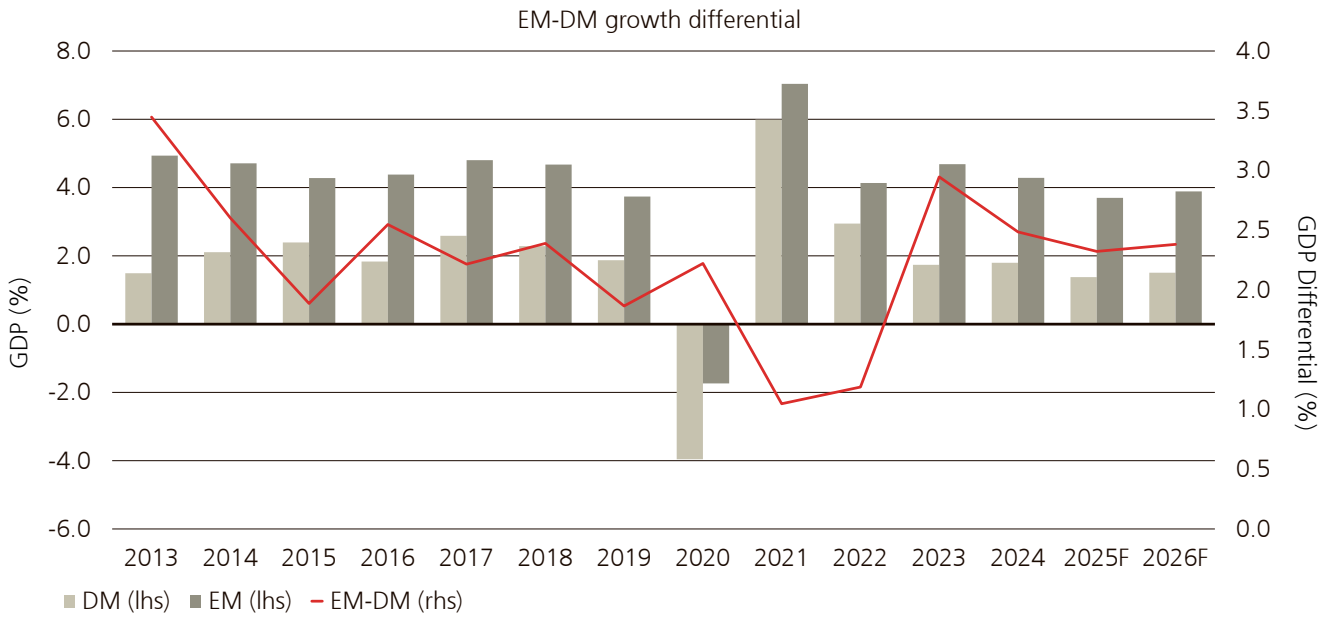
Over the past decade, emerging market sovereign debt has approximately doubled in size from around USD 700 billion in the early 2010s to USD 1.5 trillion now according to data from JPMorgan. Just under half of this debt is rated investment-grade.

Through this period, emerging market economies have grown, on average, almost two percentage points higher than developed economies (see Figure 3). This growth has not been achieved solely through increased spending. Gross government debt is still close to 70% GDP (gross domestic product), while for advanced economies it has consistently exceeded 100%.

Despite the uncertainty of potential tariffs, growth prospects for countries such as Mexico, Brazil and Poland are likely to improve, led by a pick-up in near-shoring and friend-shoring activities and in foreign direct investments as businesses adjust their global supply chain strategies. This economic growth without a commensurate increase in debt implies that debt/GDP ratios for hard currency EMD should continue to improve.

Robust emerging market economic growth also implies a rise in the number of net creditor countries. Yields on investment grade EMD are still at what we consider attractive levels. EM external debt net issuance is expected to be marginally positive, which should create an upward pressure on existing bond prices. Thus, the asset class appears to be one of the few opportunities in fixed income to invest in growing economies at attractive yield levels.

Figure 3: EM-DM growth differential



Source: IMF and Macrobond Data as of April 2025

Balanced economic policies

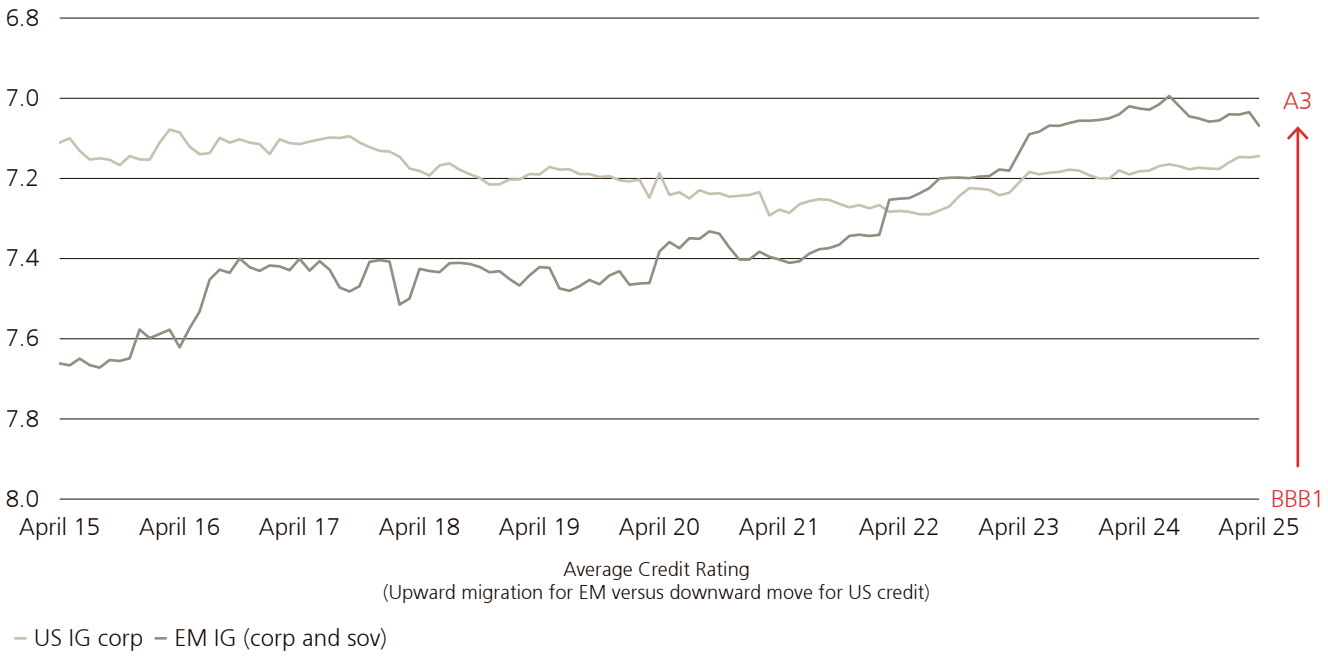
Over the past 50 years, many countries in Latin America and other emerging markets experienced recurring high inflation coupled with economic and financial crises. Central banks in these countries developed hands-on experience dealing with inflationary regimes as well as financial instability. Certain countries adopted the inflation-targeting approach from developed markets that recognizes the key role of central bank monetary policies in determining the inflation rate.

Controlling inflation has been one of the drivers of rapid economic growth and stability in output and employment in several emerging market economies. To stem inflation, many EM central banks started raising policy rates from as early as 2021, while DM central banks were still grappling with how best to respond. A case in point is the Brazilian Central Bank, which hiked rates at 12 consecutive policy meetings from a low of 2% in March 2021 to 13.75%. It decided to stop hiking only after inflation started to firmly trend lower. More recently, the Brazilian Central Bank has been hiking rates again as domestic inflation has ticked up.

Such actions have played a large part in elevating the credibility of emerging market sovereigns. Credit ratings not only for the sovereigns but also for domestic companies that have been on an improving trajectory, as shown below.

The inclusion of higher-rated Gulf Cooperation Countries (GCC) has further boosted the upward rating migration trend.

Figure 4: Improving credit ratings



Source: Bank of America, April 2025

Return of and return on capital

Liquidity and return of capital continue to be the overriding objectives from a reserve management perspective, and these have often been prioritized at the expense of returns. When looking at the returns generated from underlying investments, it is perhaps helpful to look at the Sharpe ratio – i.e., how much excess return you receive for the volatility of holding a riskier asset and is an objective metric for risk-reward.

As shown below, the return profile for emerging market investment grade (IG) debt is significantly above that of sovereign debt issued by the US or other DM sovereigns – and even broad equity indices. While the EM IG Sharpe ratio is comparable to that of US IG, the returns are higher by 0.53% on an annualized basis. Investors with longer investment horizons, such as central banks, who can ride through periodic bouts of volatility, should be well positioned to harvest this premium.

Figure 5: Sharpe ratios

Asset Class	Return	Risk	Sharpe
EMBI GD IG	4.88%	7.23%	0.68
US IG	4.35%	6.13%	0.71
US Treasuries	2.72%	4.55%	0.60
Global Treasuries	2.44%	6.93%	0.35
S&P-500	11.93%	17.15%	0.70
MSCI World	8.37%	16.98%	0.49

*2003-2024 data

Source: UBS Asset Management, Bloomberg, 2003-2024

Expanding buyer base

Sovereign debt indices, unlike equity indices, are constrained at the country level.

As of end-April 2025, Saudi Arabia has the largest weight in the JPMorgan EMBI Global Diversified index at 5.23%, while Mexico is at 4.92%. This low country concentration risk contrasts with global equity portfolios which have a massive exposure to US stocks and global emerging markets equity portfolios which have a significant exposure to stocks in China, India and Taiwan.

Historically, emerging market debt tended to be held by overseas investors. However, in certain regions such as the Middle East local institutions are now part of the buyer base. They are effectively buying dollar-denominated debt issued by their home/sovereign country – a safe haven asset for them. This has had positive implications for bond spreads and volatility.

Finally, asset allocators with longer-term investment horizons such as global insurance companies, pension funds and endowments are starting to recognize the benefits and raising their allocations to the investment grade segment of emerging market hard currency debt.

Spreads and liquidity

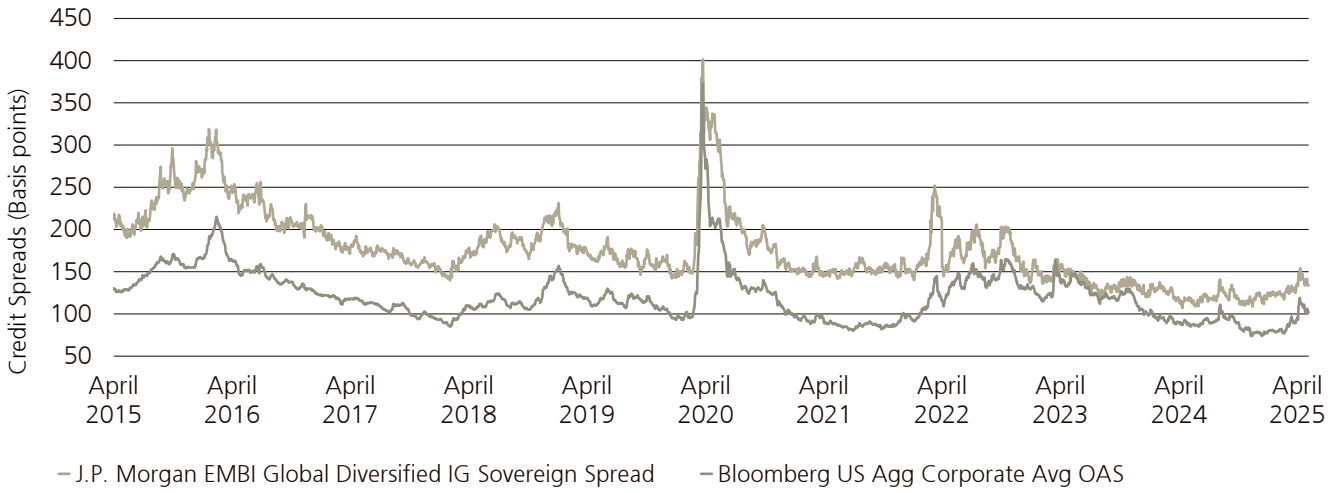
Bank failures, currency sell-offs and systemic corporate defaults have plagued emerging market countries in the past, causing their bonds to trade at a discount. However, spreads on EM IG sovereigns now move more in-line or better than US investment grade corporates (see Figure 6).

In April 2025, when tariff-related uncertainty led to a marked increase in dispersion and volatility, EM IG sovereigns held up relatively well. The percentage spread widening from end-March to end-April 2025 for US IG corporates was 13%, more than double that of EM IG sovereigns at 5%.

Prior to the Global Financial Crisis, bonds were predominantly traded by dealers and sell-side financial institutions. After Lehman Brothers filed for bankruptcy in 2008, banks had limited confidence in the ability of trading counterparties to honor their commitments. Given the nature of the trading ecosystem back then, it is perhaps unsurprising that liquidity in the bond markets dried up during that tumultuous period.

Post-crisis, regulators raised bank capital requirements and adopted other measures that reduced broker-dealers' ability and willingness to make markets in bonds. Electronic trading platforms stepped into this liquidity void and firms such as MarketAxess and TradeWeb now offer a diversified pool of liquidity, significant cost savings to institutional investors and greater trading efficiency. This is evident in the 19.3% year-on-year increase in average daily volumes for emerging market debt traded on the MarketAxess platform in 2024.

Figure 6: EM Investment Grade versus US Investment Grade Spreads



Source: Bloomberg, JP Morgan, Data as of end April 2025

Rising US tariffs and implications for emerging markets

EM hard currency debt has outperformed similarly rated US corporate debt on a year-to-date basis as well as post the tariff announcements.

EM currencies have held up well versus the dollar, which can provide EM central banks with leeway to cut rates aggressively to manage potentially lower growth. Emerging markets outside Asia generally avoided high reciprocal tariffs even before the 90-day extension. Debt issued by Asian countries should be supported by their strong external position and by lower oil prices as most Asian countries import oil should help offset tariff impacts. Most of the Asian countries targeted with initial high reciprocal tariffs also have fiscal room to mitigate any impact on growth.

More multi-lateral backing

From 2008 onwards, the International Monetary Fund (IMF) overhauled its lending framework and amended conditions linked to loan disbursements to ensure they are adequately tailored to the policies and fundamentals of the country in need. In 2019, the IMF further modernized the framework and established new guidelines to provide large, upfront financing on a precautionary basis.

Through the Resilience and Sustainability Trust, the IMF plays an ever more important role in helping countries with limited room in their budget to address long-term challenges. Quotas for individual countries have been raised by up to 70%, with the highest increases applied to the lowest-rated countries. These are countries that are most at risk of falling into distress simply because of a lack of access to funding sources.

By providing precautionary lending, the IMF helps reduce the probability of a crisis. Further, there is the possibility of the World Bank issuing partial guarantees to help EM sovereigns refinance.

A healthy choice

The investment grade emerging market debt market reflects a healthy picture of strongly growing economies with relatively low levels of indebtedness and often combined with net creditor status. In dealing with inflationary regimes, EM countries were the first to raise interest rates and are now easing rates ahead of DM countries, which should be positive for EM local debt yields.

The IMF stands ready in its role as the lender of last resort with funds that can likely be used for refinancing of sovereign debt.

EM investment grade hard currency sovereign debt is attractive on a risk/return basis when compared to other asset classes over different economic scenarios. We believe it should play an important role in central bank asset allocation considerations. Given the current uncertain backdrop, hard currency EMD can help strike the right balance between the objectives and constraints of central banks and help protect capital in real terms.

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S-06/2025 M-001386

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