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# What drives emerging markets?

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**We outline the varied factors, at home and abroad, that support EM assets.**

Global investors' appetite for emerging markets (EM) has grown through the tail end of 2025 and into this year. Part of this renewed interest is undoubtedly performance driven—EM equities (using MSCI index data) delivered a standout 34% return in 2025, their best year since 2017 and one that outpaced global peers.

But enthusiasm is also a function of an improved macro and policy backdrop, and helpful global developments, including the movement of the US dollar.

There is a risk that investors outside the region see EM assets as being overly dependent on the US dollar's direction, so there is fear that any consolidation or renewal in the US currency may excessively weigh on emerging nations.

However, our research shows that the drivers of EM performance are far more diverse and robust.

The US dollar's direction is important, but it is only one piece of a much larger puzzle.
Let's look at why we believe EM assets will benefit from resilient global growth, improving fundamentals, supportive policy environments, and commodity strength—factors that go well beyond currency fluctuations.

**EM equities.** EM stocks have performed well since January 2025, with all bar three (Czechia, India, Indonesia) delivering positive total returns. We hold an Attractive rating on EM equities for our tactical investment horizon, underpinned by robust earnings growth, favorable policy environments, and attractive valuations. The softer US dollar has certainly helped, sustaining capital inflows and improving liquidity, but the story extends to domestic drivers and innovation as well. China, India, Brazil, and Indonesia are CIO's preferred markets, reflecting secular growth opportunities, strong liquidity, and compelling local dynamics.

Earnings growth is the key engine: MSCI EM is expected to deliver the highest global EPS growth rate in 2026 at 20%, fueled by China's earnings recovery, rapid AI adoption, and resilient domestic and external demand. China's tech sector is rated Most Attractive, with government support for AI and digital platforms driving innovation and earnings and presenting a number of opportunities in a fast-evolving value chain. India's resilient growth, supported by fiscal reforms and a favorable monetary environment, adds further strength amid a more favorable trading relationship with the US following the recent trade agreement. Commodity exporters like Brazil and Indonesia should benefit from higher prices for metals and minerals, improving their terms of trade and supporting corporate profits.

Policy support is another critical driver. Fiscal stimulus in Asia, property market easing in China, and expected rate cuts in Brazil are all helping to cushion the scope for losses and boost sentiment. Improvements in corporate governance, especially in Asia, are raising return-on-equity ratios and supporting valuations. Despite recent gains, EM valuations remain attractive relative to developed markets, and global investors remain underallocated, leaving room for further inflows.

EM equities are sensitive to the US dollar, but not exclusively so. Historically, during episodes of a weakening US dollar, every 1% drop in the US dollar index (DXY) is associated with a 3.8% gain in EM equities, with LatAm (+4.7%), CEEMA (+3.8%), and EM Asia (+3.7%) all showing strong positive correlations based on our analysis and data since 2007. However, the current environment shows that earnings, innovation, policy, and increasing investor appetite to seek diversification are equally—if not more—important in driving performance.

**EM hard currency debt.** EM hard currency bonds—those denominated in US dollars or other major currencies—delivered robust returns in 2025, with sovereigns up 14.3% and corporates up 8.7%. The asset class has benefited from lower developed market yields, tighter credit spreads, and ongoing improvements in credit fundamentals, including rating upgrades and lower default rates. CIO has recently upgraded EM bonds to Attractive, expecting continued outperformance versus cash and developed market bonds.

The decline in developed market yields, as central banks like the Federal Reserve lower policy rates, has provided a tailwind for EM fixed income. Credit spreads have narrowed, reflecting improved investor confidence and healthier issuer balance sheets. The number of distressed issuers with spreads above 1,000 basis points has declined, signaling a more stable environment. Commodity strength has further improved fundamentals, with exporters like Chile, Brazil, and South Africa benefiting from higher prices and better trade balances.

EM hard currency debt is sensitive to the US dollar, especially for issuers with large external debt. A weaker dollar eases debt serviceability and attracts investor flows, while a stronger dollar can tighten financial conditions and raise risks. However, high outright yields (currently 6-7%) and supportive central bank policies provide a buffer against volatility, making EM bonds a key diversifier for global investors, especially as developed markets face rising worries about fiscal fragility and the questions about the sustainability of government debt levels.

**EM currencies.** EM currencies had a strong first half of 2025, followed by a sideways trend as the US dollar stabilized. High-yielding currencies like the Mexican peso, Brazilian real, and South African rand continued to deliver solid total returns, supported by elevated nominal and real yields, resilient economic growth, and helpful commodity prices. CIO expects these positive drivers to remain in place for 2026.

The outlook for EM currencies is shaped by three main factors. First, real yields remain high, as EM central banks have cut rates less aggressively than the Fed, and inflation is under control in most markets. Second, global growth remains resilient, with fiscal stimulus in major economies providing support. Third, EMs offer diversification and appealing domestic dynamics, such as structural reforms in South Africa and a return to more orthodox policies in Türkiye.

While the links between EM currency performance and the US dollar are arguably most explicit, we note a couple of important points. First, domestic factors—such as policy choices and fiscal discipline—can offset or amplify the impact of dollar moves. Second, the fact many appealing EM currencies pay higher interest rates than those in developed markets mean that spot market moves in the US dollar can be offset by returns from interest rate differentials (also known as carry).

With EM currencies, CIO prefers diversified exposure to high-yielding currencies, including the BRL, MXN, INR, ZAR, and TRY, and maintains a positive view on the Egyptian pound, which offers attractive carry and low volatility.

Risks remain, including potential disappointments in global growth, trade frictions, and idiosyncratic country risks. However, the combination of high yields, resilient fundamentals, and supportive global conditions makes EM currencies an appealing opportunity for investors seeking diversification and exposure to carry, in our view.

We continue to believe EM assets can show resilience and deliver potential gains in 2026, despite geopolitical tensions and policy uncertainty, thanks to a much richer and more diverse set of drivers than the ebbs and flows of the US dollar. We advocate a diversified investment approach to EM assets, using varied tools that may include active investment approaches, exposure to portfolio building blocks, and select structured strategies. Above all, we think many international investors who have held fewer EM assets than their long-term goals should take the opportunity to review portfolios and revise allocations in order not to miss out on potential 2026 portfolio gains.

**With thanks to Tilman Kolb and Xingchen Yu (UBS Chief Investment Office) for their contributions.**

Appendix

**Non-traditional asset classes are alternative investments that include hedge funds, private equity, private credit, real estate, and managed futures (collectively, alternative investments).** Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. **An investment in an alternative investment fund is speculative and involves significant risks.**

Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

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- **Real Estate:** There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.

- **Private Equity:** There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.

- **Private Credit:** There are risks specifically associated with investing in private credit. This could include losses stemming from defaults on loans, which in significant adverse circumstances could result in a substantial loss of investment.

- **Foreign Exchange/Currency Risk:** Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.

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