

Strategic allocation: EM investment grade hard currency debt

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Investment strategies for conservative fixed income portfolios are contingent on a multitude of factors including capital protection, liquidity, return and regulatory requirements for certain investors. Optimizing along these parameters inevitably involves making trade-offs.

Through the era of ultra-low interest rates and subdued volatility that prevailed after the Global Financial Crisis, returns from fixed income, especially within investment-grade were lackluster. This prompted investors to broaden their investable universe beyond just publicly traded 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. In this new environment, bonds are likely to play a crucial role not only in terms of capital protection, but also as a source of income.

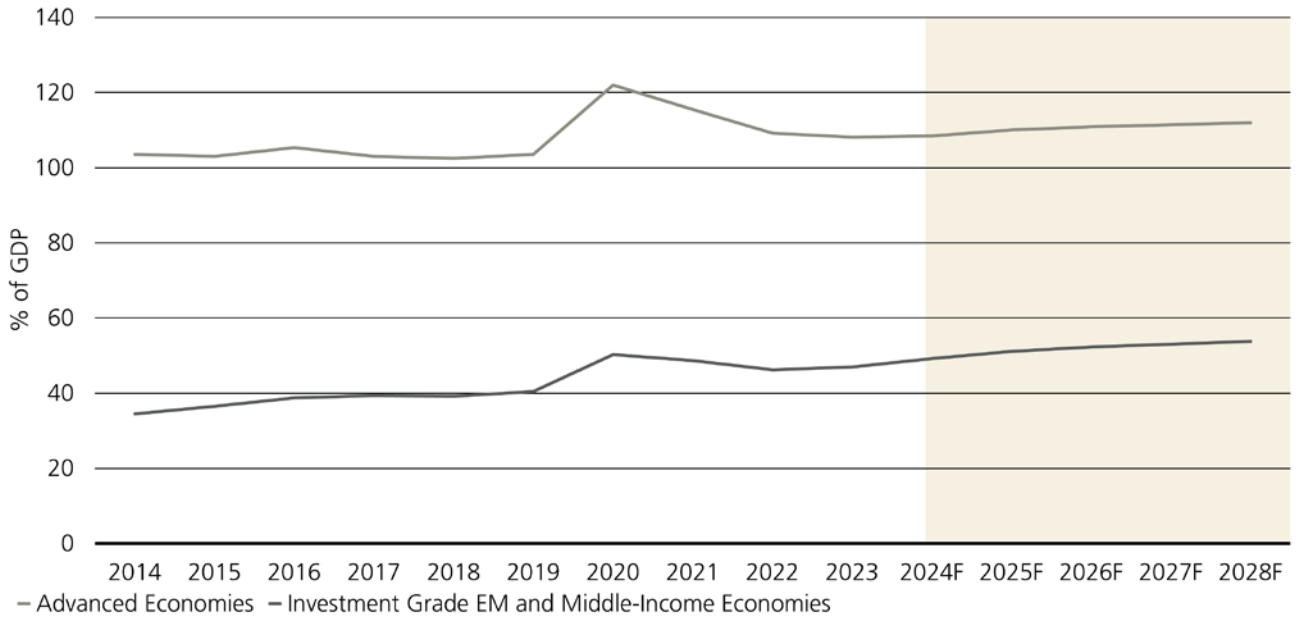
Emerging market (EM) investment grade debt in hard currency is an asset class that strikes a unique balance between competing constraints highlighted earlier, while also potentially making a significant contribution to protecting capital in real terms.

Robust fundamentals

Over the past decade, emerging market sovereign debt has approximately doubled in size from around USD 700 billion in the early 2010s to USD 1.4 trillion now, according to data from JPMorgan. Emerging market corporate debt has grown at an even higher rate and is now at USD 2.5 trillion. Just over half of all this debt is rated investment-grade.

Through this period, emerging market economies including frontier countries have on average grown by more than 4% and companies domiciled in these countries have generally benefited as well. This growth has not been achieved solely through increased spending. As per IMF data, gross government debt on average for advanced economies is well above 100% while for investment-grade emerging economies it hovers close to 50%.

Figure 1: Government gross debt forecast

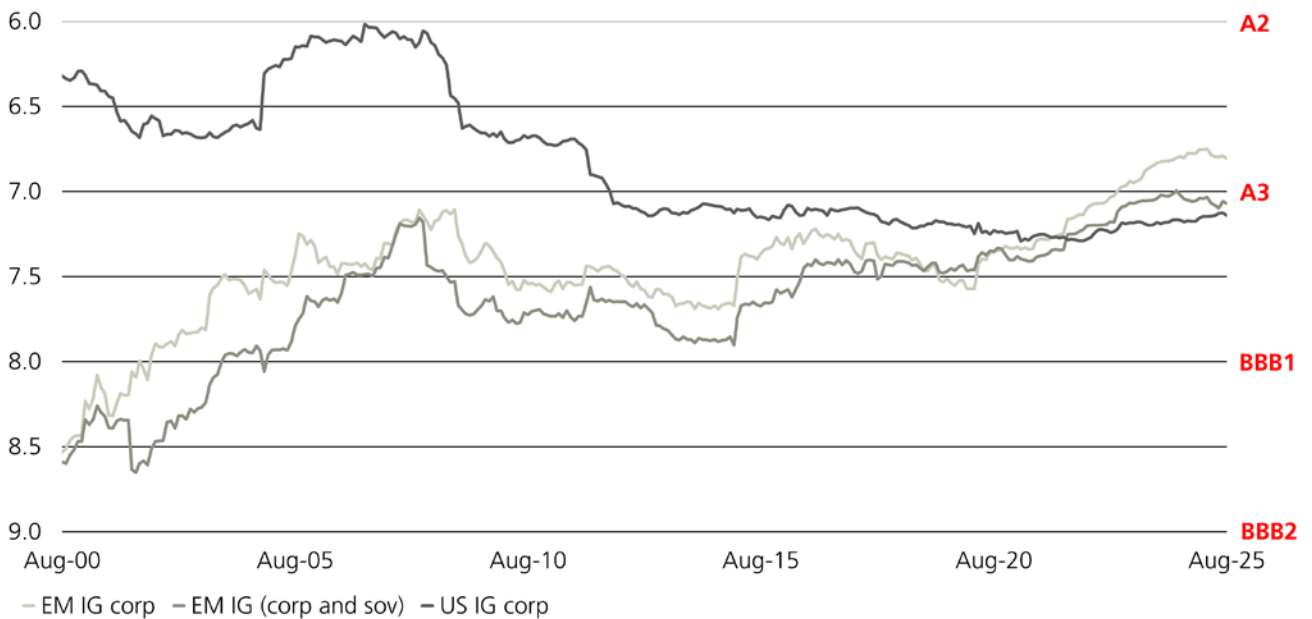


Source: IMF and Macrobond Data as of April 2025

Net leverage for emerging market companies rated investment grade has dropped to a decade low of 1.2x and is significantly lower than US investment grade peers which are at 2.8x.

Credit ratings for sovereigns and domestic companies have both been on an improving trajectory, as shown below. EM investment grade sovereigns and corporates are now rated better than US investment grade companies and despite that they still offer higher yields.

Figure 2: Improving ratings trajectory



Source: Bank of America, June 2025

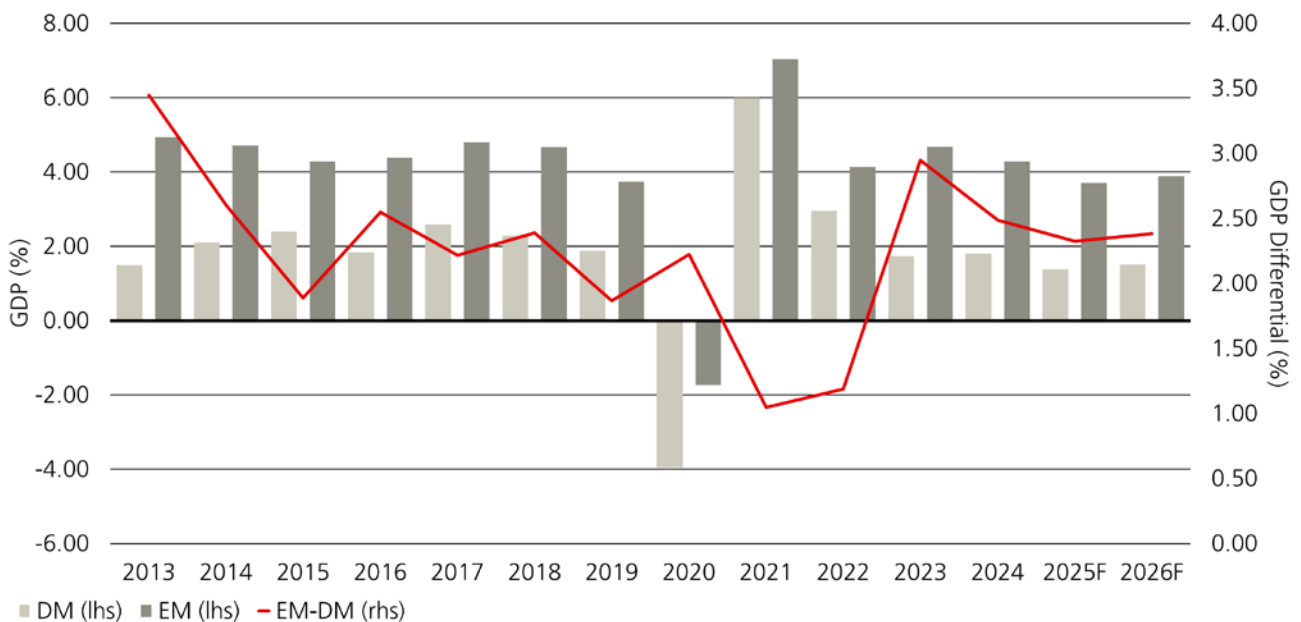
Balanced economic policies

Over the past 50 years, many countries in Latin America and other emerging markets experienced recurring high inflation coupled with economic and financial crises. 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 a number of emerging market economies. Such actions have played a large part in elevating the credibility of emerging market sovereigns.

Despite the uncertainty of tariffs, growth prospects for countries such as Mexico and Poland are likely to improve, led by a pick-up in near-shoring and friend-shoring activities and an increase in foreign direct investments as businesses adjust their global supply chain strategies. According to IMF forecasts, growth in emerging markets is expected to be stable around the 4% mark.

Figure 3: EM-DM growth differential



Source: IMF and Macrobond Data as of April 2025

Strong technicals

Sovereign and corporate debt indexes, unlike equity indexes, are constrained at the country level. As of end-June 2025, Saudi Arabia has the largest weight in the J.P. Morgan EMBI Global Diversified Investment Grade index at 10.5% followed by Indonesia at 9.0%. Equivalent country exposures for the J.P. Morgan CEMBI Broad Diversified Investment Grade index stand at 9.3% for China and 7.4% for South Korea. This relatively low country concentration risk contrasts with global equity portfolios which have

massive exposure to US stocks or global emerging markets equity portfolios tracking the MSCI Emerging Markets Index which have over 80% exposure to stocks in China, Taiwan, India, South Korea and Brazil.

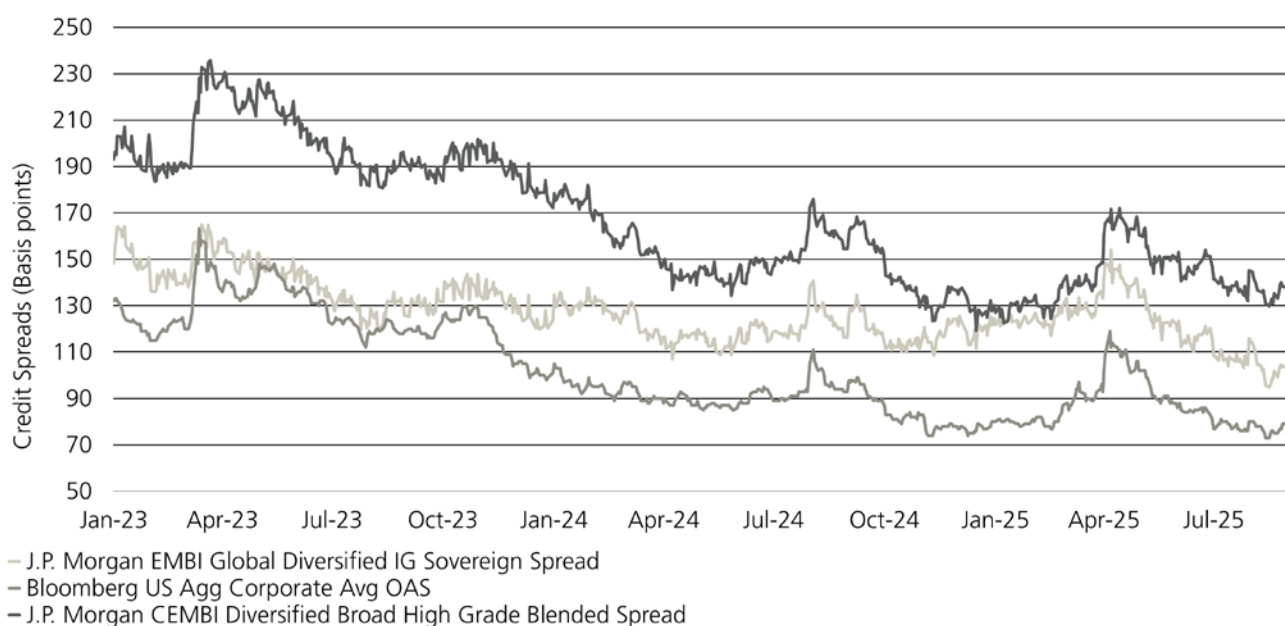
EM external debt net issuance for sovereigns and corporates combined is expected to be muted relative to recent past, which should create technical demand that could put upward pressure on existing bond prices.

Spreads and liquidity

Bank failures, currency sell-offs and systemic defaults have plagued emerging market debt in the past, causing bonds to trade at a discount. However, spreads on EM IG sovereigns and corporates now move more in line with, or better than, US investment grade corporates. In April 2025,

when tariff-related uncertainty led to a marked increase in dispersion and volatility, EM IG sovereigns and corporates held up relatively well. A similar dynamic was observed in March 2023, when US regional banks such as SVB Group failed due to of a mismatch in assets and liabilities, which roiled other regional US bank stocks and bonds as well.

Figure 4: EM IG outperformed US IG spreads



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

Historically, emerging market debt was held by overseas investors. However, in regions such as the Middle East and Asia, local institutions have become a substantial component of the investor base. They are effectively buying dollar-denominated debt issued by their home/sovereign country and local corporates – a safe and familiar asset for them. This has had positive implications for bond spreads and volatility.

Prior to the Global Financial Crisis, bonds were predominantly traded by dealers and sell-side financial institutions. 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 trading volume for emerging market debt on the MarketAxess platform in 2024.

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 in 2025, including in the wake of the tariff announcements. EM currencies have held up well vs. the dollar, which may provide EM central banks leeway to cut rates aggressively to manage threats to growth. Emerging markets outside Asia generally avoided high reciprocal tariffs even before the 90-day extension. We believe debt issued by Asian countries should be supported by their strong external position and by lower oil prices as most Asian countries import oil, which should help offset the impact of tariffs. Most of the Asian countries targeted with initial high reciprocal tariffs also have fiscal room that may mitigate any impact on growth.

Return of and return on capital

Liquidity and return of capital continue to be the overriding objectives for conservative fixed income investors. When looking at the returns generated from underlying investments, it is often helpful to look at the Sharpe ratio, a common risk-reward metric, which measures how much excess return you receive for the volatility of holding a riskier asset.

According to analysis of Sharpe ratios, the return profile for emerging market investment grade (IG) debt within sovereigns and corporates is significantly above that of sovereign debt issued by the US, other DM sovereigns and US investment grade companies.

EM IG corporate debt has the highest annualized return among the fixed income assets highlighted below, but what makes it even more appealing is that these returns are achieved with the lowest volatility across equities and fixed income segments. While the EM IG sovereign 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, who can ride through periodic bouts of volatility, could be well positioned to harvest this risk premium.

Figure 5: Sharpe ratios

Asset Class	Return	Risk	Sharpe
EM IG Sovereign	4.88%	7.23%	0.68
EM IG Corporate	4.99%	4.51%	1.10
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

Source: UBS Asset Management, Bloomberg, 2003-2024

1 Source: Bloomberg, UBS Asset Management. Data from Jan 2003 - Dec 2024. Bloomberg indices: EMD IG Sovereign: JPGCIG Index, EMD IG Corporate: JBCEIG Index, US IG: LUACTRUU Index, US Treasuries: LUATTRUU Index, Global Treasuries: LGTRTRUU Index, All indices are in US dollar terms.

Summary

Investment grade emerging market debt market reflects a healthy picture of strongly growing economies and companies with relatively low levels of indebtedness and often combined with net creditor status for sovereigns. In our view, EM investment grade hard currency debt is attractive on a risk-return basis when compared to other asset classes over the last twenty-plus years.

Conservative fixed income investors with longer-term investment horizons such as global insurance companies, pension funds, endowments and family offices are starting to recognize these benefits, which include the highest yields and spreads adjusted for their ratings categories. These investors have been increasing their allocations to the investment grade segment of emerging market hard currency debt, which should also be supportive for the market.

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