



Emerging Markets Fixed Income looks set to benefit from constructive conditions 2026 – driven by positive macroeconomic shifts, currency dynamics and investor positioning. LGT Capital Partners' Emerging Markets Fixed Income team sees multiple tailwinds supporting both local and hard currency strategies, while acknowledging that a few key risks remain.

## Dollar depreciation and global diversification

We expect the US dollar to continue depreciating in 2026. This trend is driven by global investors' diversification needs, elevated valuations in US technology stocks and slightly improving growth prospects in the EU. The growth differential favoring emerging and frontier markets, as well as the ongoing expansion of trade between emerging and frontier market countries, further reinforce this outlook. A weaker US dollar has historically been supportive of emerging and frontier market currencies and enhances returns for local currency bonds. According to our estimates, most emerging and frontier market currencies continue to have attractive valuations, meaning that they can be expected to appreciate against the dollar in the long run.

## Rates volatility and sovereign risk premium underscore relative strength of emerging and frontier market debt

High indebtedness in western economies increases the likelihood of rate volatility, which paradoxically benefits emerging and frontier market assets. Sovereign risk premia in emerging and frontier market debt are poised to shrink further, reflecting improved fiscal discipline and robust external debt profiles. External vulnerabilities remain contained and refinancing risks are concentrated in a handful of small economies that will not impact the broader asset class. The potential cancellation of

International Emergency Economic Powers Act (IEEPA) tariffs by the US Supreme Court and subsequent legal uncertainty may delay corporate purchasing decisions in the US, dampening domestic momentum. This factor is adding to the mood of caution among US businesses, as reflected in recent surveys. For emerging and frontier market debt, the removal of tariffs – or even stability in the tariff environment – is positive and supports lower risk premia.

Inflation in emerging and frontier markets has generally been on a downward trajectory despite service inflation often still exceeding the target. Food and fuel inflation has been contained, supporting local rates and bond markets.

## Main risk is higher than expected growth in US

Consumer confidence in the US remains subdued compared to historical averages. The previous strong demand for labor has slackened and although potential growth is constrained by reduced immigration, it could prompt the US Federal Reserve (Fed) to cut rates early in the year despite long-term inflationary implications. The main risk is that US growth, boosted by AI investment and government spending, could be stronger than expected. This might stop the Fed from making any significant rate cuts and increase the gap compared to rates in Europe. A higher-than-expected US policy rate would also set a more challenging hurdle rate for emerging and frontier market debt.

## Potential equity market correction and emerging and frontier market currency impact

If expensive tech stocks fall because AI expectations change, this could cause short-term swings in more volatile emerging and frontier market currencies. Over the medium term, however, a correction such as this would likely favor emerging and frontier market currencies as capital rotates away from US equities towards higher-yielding alternatives.

## Return expectations: frontier, local and hard currency debt

A weaker US dollar remains a key factor supporting emerging and frontier market local currency bonds. Combined with a current yield of around 6%, we project total returns of 8–10% (in USD) in our base case for 2026. Frontier markets also stand to benefit: the supportive macro backdrop reduces typical nominal depreciation, allowing returns to align with running yields near 15% (in USD).

For emerging and frontier market hard currency bonds, reduced demand for US technology shares will help cap treasury yields. We expect positive returns of 7–9% (in USD) in 2026, with some risk of slightly higher yields for better-rated sovereigns if global growth surprises to the upside. Importantly, emerging and frontier market external debt profiles are solid and refinancing challenges are limited to marginal issuers. The high-yield segment of the asset class can still continue to perform.

## Investor positioning and flow trends

Recent surveys and flow data confirm persistent inflows into emerging and frontier market bond funds, marking a sharp reversal from the substantial outflows of previous years. Local currency funds have led this trend, supported by expectations of dollar weakness and attractive real yields. Hard currency strategies also benefit from improving credit fundamentals and tighter spreads, as highlighted in recent issuance trends and positive credit rating developments.

## Tail scenarios

The main risk scenario involves US growth exceeding 2%, preventing further Fed cuts and sustaining a strong dollar. The tail risk is the opposite: a broader equity correction spilling into credit markets. This risk is mitigated by the resilience of private markets and healthy capital adequacy among global banks.

## Bottom line

Emerging Markets Fixed Income is expected to offer compelling opportunities in 2026. Local currency strategies should deliver high single-digit returns, while frontier markets could achieve mid-teens performance. Hard currency bonds remain attractive, supported by solid fundamentals and capped US yields. While risks persist, the balance of factors such as dollar depreciation, rate volatility and structural improvements in emerging and frontier market should position the asset class as a key diversifier with strong return potential.

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