

White Paper

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Dollar Weakness Creates an Opportune Moment for Emerging Markets Debt

Authors



Ward Brown
Fixed Income
Portfolio Manager



Laura Reardon
Fixed Income Institutional
Portfolio Manager



Katrina Uzun
Fixed Income Institutional
Portfolio Manager

Key Takeaways

- **A weak US dollar improves EM debt appeal:** Recent dollar weakening provides a strong tailwind for emerging market debt, especially local currency bonds, supported by improved EM fundamentals.
- **Favorable macro and policy dynamics:** Structural factors in the US (e.g., twin deficits, overvalued dollar, dovish Fed outlook) and EM central banks' ability to ease policy due to contained inflation create a supportive environment for both hard and local currency EM debt.
- **Attractive entry point for investors:** Elevated yields in EM hard currency bonds and improving local currency dynamics offer compelling risk-adjusted returns.

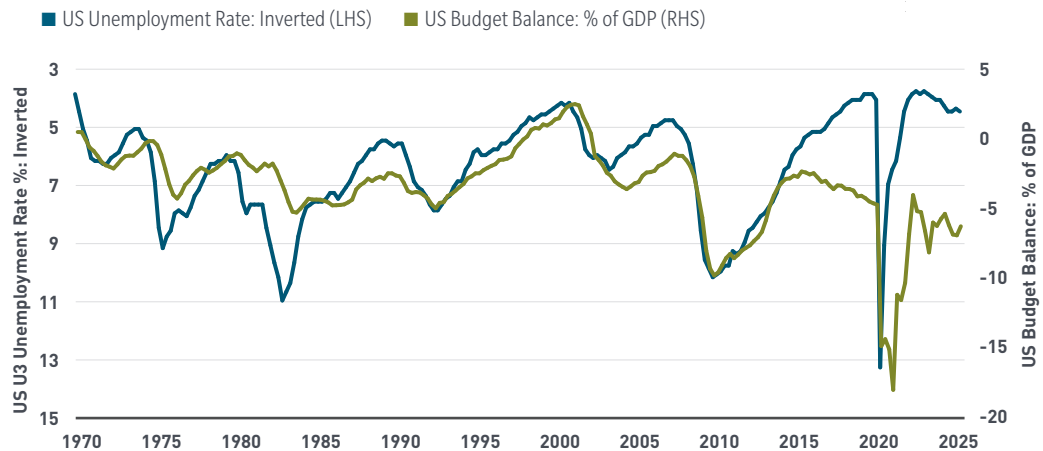
The recent weakening of the US dollar, following a decade-long period of strength, has created a significant tailwind for emerging markets (EM) debt. This shift comes at an opportune time: the asset class has grown more resilient in recent years, as many EM economies have strengthened their balance sheets and returned inflation to target. Combined with higher yields across both hard and local currency debt, the environment offers an attractive investment proposition.

For active managers, the backdrop is particularly favorable. A weaker dollar enhances the appeal of local currency EM debt, while also continuing to support hard currency debt — providing opportunities across the broader EM universe.

Why the dollar is vulnerable

Several factors support the further depreciation of the US dollar — conditions that historically have been favorable for emerging markets debt, particularly EM local currency assets. Four key drivers underpin our view:

- **Valuation:** By most metrics, the US dollar is trading at elevated levels relative to historical norms. This overvaluation suggests limited upside and increases the risk of mean reversion, especially in an environment where structural supports for dollar strength are eroding.
- **Positioning:** Investor positioning is heavily skewed toward the dollar. A shift in sentiment or fundamentals could lead to a broad-based reallocation away from the dollar and into undervalued currencies, including those in EM.
- **Fundamentals:** The US is running substantial twin deficits (fiscal deficit and current account). With deficits widening even in a low unemployment environment — exacerbated by recent fiscal packages — long term vulnerabilities weigh on the dollar.

Exhibit 1: The divergence of US unemployment and fiscal deficit is unsustainable

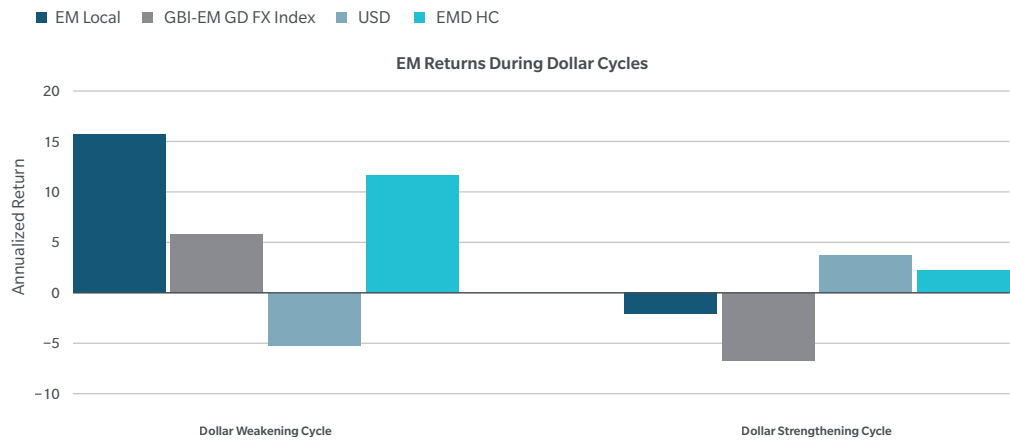
Source: Bloomberg. Quarterly data from December 1969 through June 2025 for US Unemployment; through June 2025 for US Budget Balance % of GDP. US unemployment rate represented by the U3 US unemployment rate seasonally adjusted.

As you can see in exhibit 1, even with the US at full employment and unemployment below 4%, the fiscal deficit is running at about 6% of GDP. That divergence is unsustainable. Furthermore, with the passage of the latest fiscal package — the One Big Beautiful Bill Act (OBBBA) — the deficit is set to widen even further over the next few years. This fiscal trajectory is likely to put sustained pressure on the dollar.

- **Policy outlook:** The US administration has shown little resistance to a weaker dollar, removing a key support for the currency. Additionally, expectations that the Federal Reserve will resume its rate-cutting cycle this year further erode a critical pillar underpinning dollar strength.

Together, these drivers point to continued dollar weakness — an environment that supports both EM hard and local currency bonds, as illustrated in exhibit 2. A weaker dollar generates beneficial secondary effects for EM assets. It allows many countries to build higher foreign exchange reserves, which provide buffers against global volatility and help stabilize local currencies. It also reduces the cost of servicing hard currency debt, easing fiscal pressures. In addition, a softer dollar tends to lift commodity prices, which is especially supportive for commodity-exporting EM economies. Taken together, these effects strengthen what is already a supportive global backdrop for EM.

Exhibit 2: Dollar depreciation benefits EM debt

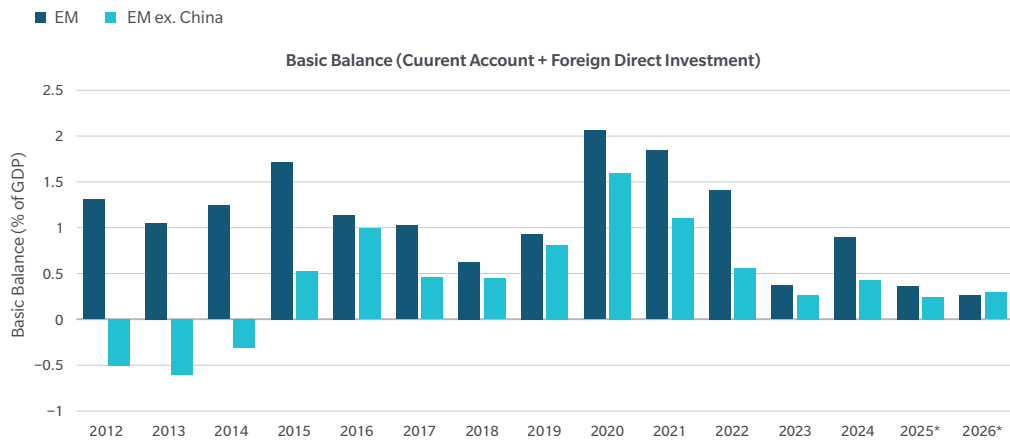


Source: Bloomberg. Monthly data from January 2003 through October 2022. EM Local = JP Morgan GBI EM Global Diversified Index. USD = US Dollar Spot Index (DXY). GBI-EM GD FX Index = J.P. Morgan GBI-EM Global Diversified FX return Index. EM HC = J.P. Morgan EMBI Global Diversified Index. Dollar Weakening Cycle = 31 Jan 2003 - 30 Apr 2008. Dollar Strengthening Cycle = 31 Jul 2011 - 31 Oct 2022.

EM fundamentals are stronger

Since the pandemic, many emerging market countries have made significant progress in strengthening their economic foundations. Balance sheets have improved, fiscal consolidation is underway — aimed at reducing deficits and ensuring long-term sustainability — and current account balances are strong.

Exhibit 3: EM external accounts remain strong



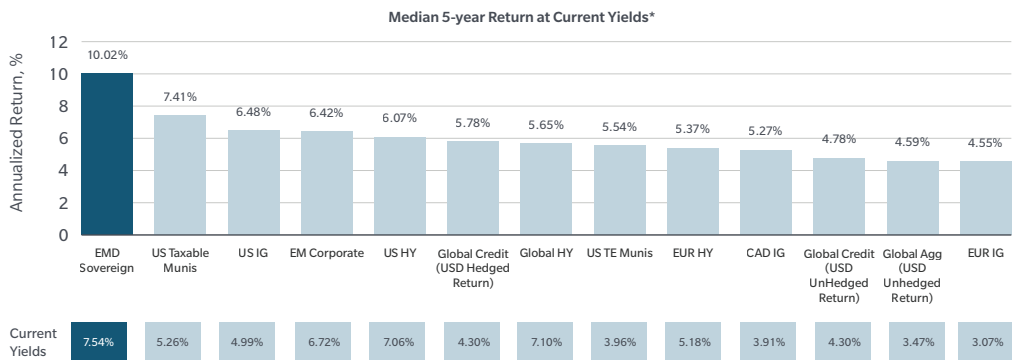
Source: EIU, MFS Research. Annual data from 31 December 2012 through 31 December 2026. 2025* and 2026* represent MFS forecasts as of 30 June 2025. Basic Balance = Current account + foreign direct investment. EM = China, India, Indonesia, Malaysia, Philippines, Thailand, Russia, Czech Republic, Hungary, Poland, Romania, South Africa, Turkey, Brazil, Chile, Colombia, Mexico, Peru and Uruguay.

Additionally, inflation has returned to target ranges in most EM economies as a result of prudent and proactive monetary policy over the last few years. With inflation under control, many EM central banks have been able to commence their easing cycles, providing an additional tailwind for investing in local rates and reinforcing the investment case for EM debt.

Elevated yields present attractive entry points

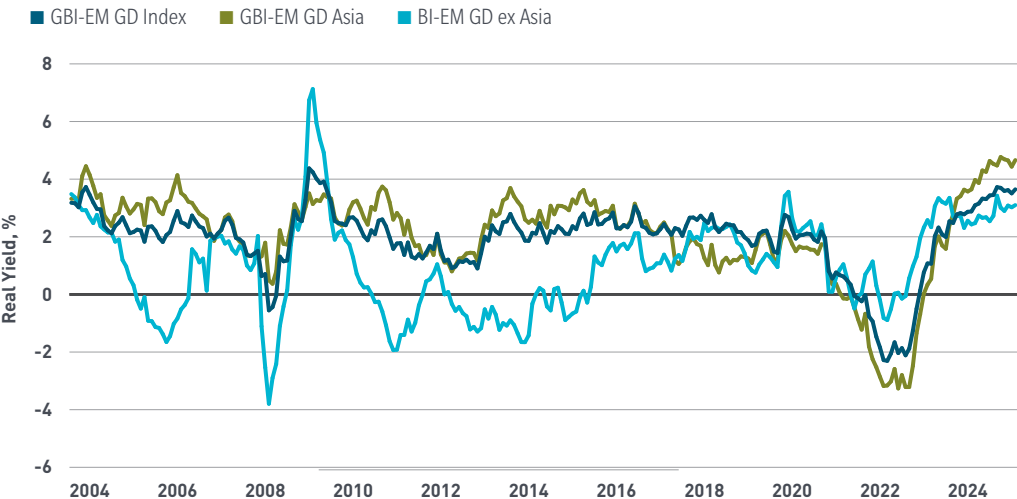
At the same time, yields in both hard and local currency remain at elevated levels, offering attractive entry points for investors. For example, hard currency yields are currently trading above historical medians. Historically, when starting at similar yield levels, the asset class has delivered a median annual return of around 10% over five-year periods. In today’s market, investors are positioned to benefit not only from higher yields, but also from diversification and the tailwind of improving macroeconomic fundamentals across emerging economies.

Exhibit 4: The strategic power of entry points across global fixed income



Source: Bloomberg. Monthly data from December 2008 through June 2025. Current yield-to-worst as of 30 June 2025. *Median annualized returns shown calculated using observations for which yields ranged +/- 30 bps from the current yield for each asset class. EMD Sovereign = J.P. Morgan EMBI Global Diversified Index. US IG Corp = Bloomberg US Aggregate Corporate Index. Global HY = Bloomberg Global High Yield Index. US Taxable Munis = Bloomberg US Taxable Municipal Aggregate Eligible Index. US HY = Bloomberg US Corporate High Yield Index. EM Corporate = J.P. Morgan Corporate EMBI Broad Diversified Index. EUR HY = Bloomberg Pan-European High Yield Index. Global IG = Bloomberg Global Aggregate Corporate Index. EUR IG = Bloomberg Pan-Euro Aggregate Corporate Index. Global Agg = Bloomberg Global Aggregate Index. Past performance is no guarantee of future results.

Exhibit 5: GBI-EM Index Real Yields



Source: JP Morgan, Bloomberg. Monthly data from 31 January 2004 through 31 July 2025. Nominal index yields sources from JP Morgan and deflated by the index weighted CPI inflation rate of all countries in the GBI-EM GD index or countries within each stated region within the GBI-EM GD index. GBI-EM GD = J.P. Morgan Global Diversified Index. GBI-EM GD Asia = J.P. Morgan Global Diversified Asia Index. GBI-EM GD ex Asia = J.P. Morgan Global Diversified ex-Asia Index.

Summary

The combination of dollar weakness, stronger EM fundamentals, and elevated yields creates a uniquely favorable environment for emerging markets debt. We believe both hard and local currency segments are well placed to deliver attractive, risk-adjusted returns, presenting a compelling opportunity for investors. ▲

Important Risk Considerations:

Emerging markets can have less market structure, depth, and regulatory, custodial or operational oversight and greater political, social, geopolitical and economic instability than developed markets.

Investments in debt instruments may decline in value as the result of, or perception of, declines in the credit quality of the issuer, borrower, counterparty, or other entity responsible for payment, underlying collateral, or changes in economic, political, issuer-specific, or other conditions. Certain types of debt instruments can be more sensitive to these factors and therefore more volatile. In addition, debt instruments entail interest rate risk (as interest rates rise, prices usually fall). Therefore, the portfolio's value may decline during rising rates.

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