



The end of exorbitant privilege?

EMD report Q3 2025

Mohammed Elmi, CFA
Senior Portfolio Manager,
Emerging Market Debt

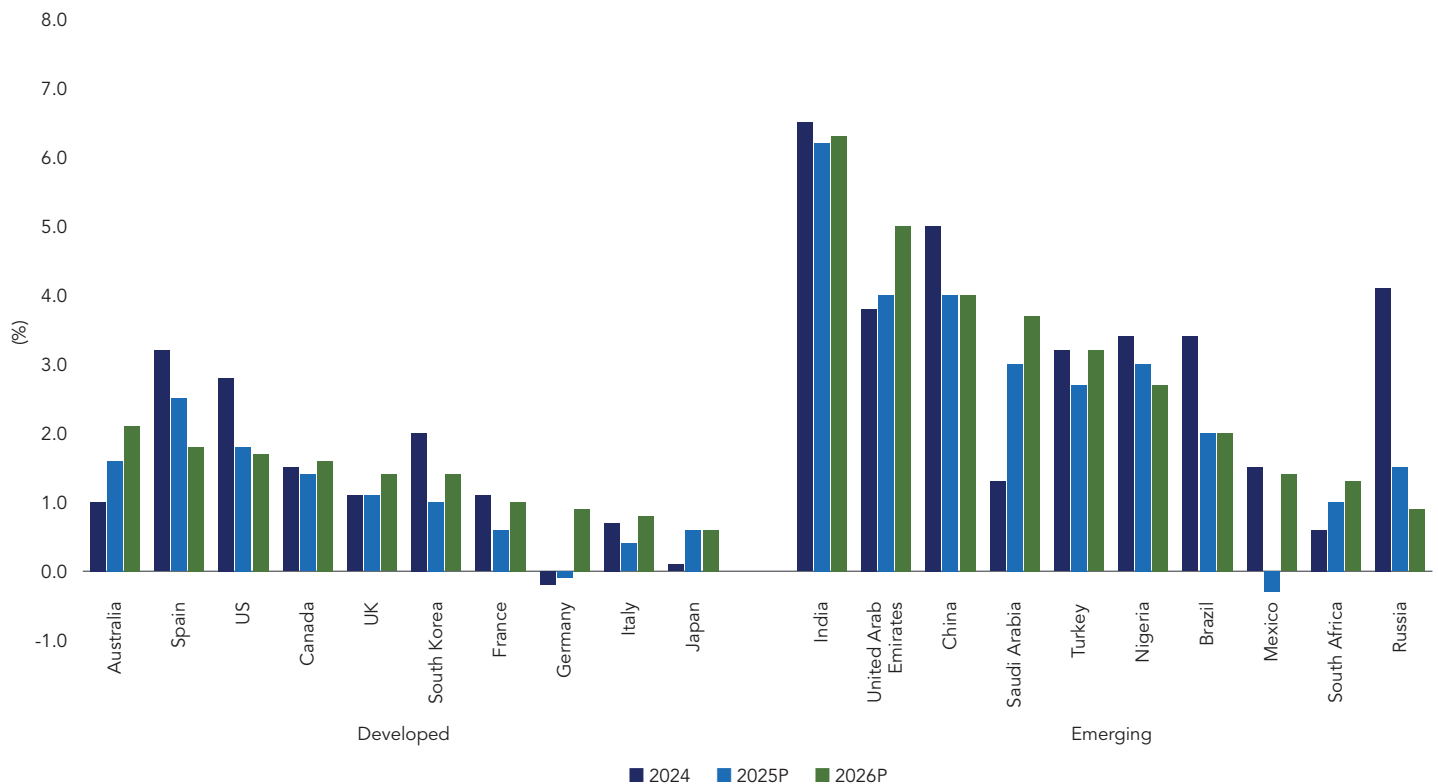
Jason DeVito, CFA
Senior Portfolio Manager,
Emerging Market Debt

Fast-developing economies are transforming global markets

The dramatic shift in trade policy this year by the new US administration initially laid bare a fissure across developed markets (DM) that hides in plain sight. While announcements of the end of US exceptionalism and expectations for a monumental disruption in asset flows now seem overstated, the long-term shift in fundamentals is not.

The post-global financial crisis (GFC) era saw a massive transfer of debt from the private sector to public balance sheets as governments in DM bailed out private enterprise. This became the template for the debt accumulation binge in DM. The new model featured countercyclical/easy money policies designed to keep economies afloat and allowed steady debt accumulation at low rates. Policymakers proved unable to either kick the debt habit or move beyond easy money. And then the pandemic hit, producing round two of massive stimulus from monetary and fiscal policy as debt funded fiscal stimulus and quantitative easing (QE).

Figure 1: GDP projections



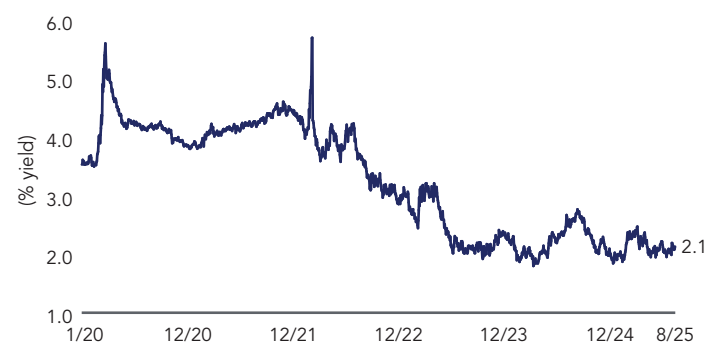
Source: International Monetary Fund (IMF) as of April 2025

A world of difference

Now again, with Covid in the rearview mirror, policymakers refuse to face long-term reality and continue to borrow and spend. This has driven debt/GDP ratios to equal or surpass national income in most DM countries. Front and center, in the US, the Congressional Budget Office estimates the "One Big Beautiful Bill" will lower tax revenues by US \$3.7tr over the next 10 years, while proposed spending cuts would only save US \$1.3tr, leaving the primary deficit US \$2.4tr wider than would otherwise have been the case. Moody's became the third ratings agency to downgrade US debt in May, before the bill passed, contributing to the nascent "sell America" theme that emerged with the "Liberation Day" dramatics of early April.

The emerging market (EM) local currency yield versus the US 5-Year Treasury bond shows that local yields have compressed to US yields over time — growing acceptance that EM risk has deteriorated.

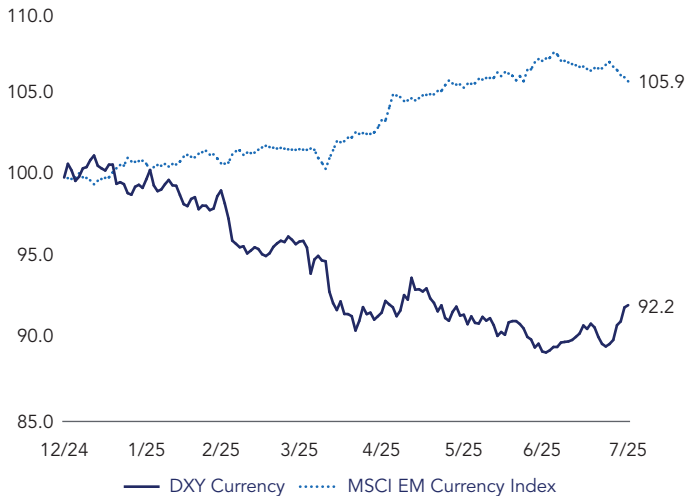
Figure 2: EM local risk premium over UST



Source: Bloomberg as of 13/8/25

At the halfway point of 2025, the weakest US dollar since 1973 is the other top headline. President Trump has been outspoken about wanting a weaker dollar, in theory to make US goods prices “more competitive.” His tariff and policy announcements since taking office for the second time have resulted in downward pressure on the USD against both DM and EM currencies, primarily because global investors have been reducing their exposure to US assets. As markets have managed to calm somewhat entering the second half of the year, the fundamentals of the “sell America” trade remain in place, with the scope and depth of the trend yet to be determined.

Figure 3: Dollar divergence (Index values = 100 as of 31/12/24)



Source: Bloomberg as of 31/7/25

EM country profiles

Turkey

Turkey's economic transformation since the introduction of orthodox policies in H2 2023 has been remarkable. Material fiscal consolidation, highly restrictive monetary policy and measures designed to reduce the stock of foreign exchange (FX)-linked deposits has significantly reduced vulnerabilities.

FX reserves increased materially thanks to deposit dedollarisation, and the current account deficit fell to just 1%. Inflation has continued its downward trend printing at 33.5% in July 2025 from a peak of 80% in late 2022. This allowed the Central Bank of Turkey to restart its rate-cutting cycle with a 300 basis point (bp) cut in late July. Nevertheless, the policy rate remains amongst the highest in the world at 43%, demonstrating remarkable political commitment to bringing inflation down.

Within the Turkey complex, we view Turkey local bonds and currency as attractive given the high level of carry interest and the rebuild of FX reserves after a short bout of volatility in late April. We also see value in Turkish banks hard currency bonds and select corporates. We remain cautious on corporates with high exposure to domestic consumption and high level of expensive domestic debt.

Nigeria

Over the past two years, Nigeria has made notable strides in economic reform and recovery, driven by bold policy changes under President Bola Ahmed Tinubu's administration. Key reforms include the removal of fuel

That was then

EM countries were hit hard in 2013 during the infamous taper tantrum as the Bernanke Fed's reduction in bond purchases (QE) created, in addition to broad market disruption, “the fragile five” — referring to Indonesia, Turkey, India, South Africa and Brazil. Since that time, the ongoing convergence of the broader set of EM economies with their DM counterparts has been dramatic, especially when we consider that typically, external debt acts as a restrainer on EM policymakers, who don't enjoy the same latitude from markets as their DM peers. Nor do they benefit from what economist and policy expert Ken Rogoff calls the ‘exorbitant privilege’ afforded to the US dollar via reserve currency status.¹

This is now

As with any market disruption, after the initial shock wears off, the focus shifts to longer-term outcomes. In terms of opportunity across emerging-market debt (EMD), tariff disruptions and DM debt/GDP ratios potentially amplify existing trends.

Uncertainty around US policy, external and internal, are telegraphed daily in yield volatility at the long end. US high yield is back to being priced for perfection and assumes a world where growth persists in spite of tariffs and without spiking inflation and employment disruptions. There are many ex-US economies that are currently more attractive. In terms of EMD, opportunity drivers include:

- EMD ownership is at a 20-year low as investors stayed away post Covid in favor of DM and private debt.
- Despite general tariff concerns, many EMD opportunities exist out of the storm path and potentially benefit from a weaker USD environment.
- In addition to USD and local currency opportunities, many EM countries offer attractive yield and diversification potential.

subsidies and liberalisation of the foreign exchange market, and cessation of central bank financing of fiscal deficits. These measures have helped stabilize macroeconomic fundamentals, boost investor confidence and attract foreign capital, with portfolio investments surging to US \$3.48b in the first half of 2024.

Nigeria's GDP growth rebounded to 3.4% in 2024, supported by increased oil production and a vibrant services sector. Inflation, while still high, has begun to ease, and international reserves have strengthened. Credit rating upgrades by Fitch and Moody's reflect growing optimism about Nigeria's fiscal discipline and reform sustainability. Despite persistent challenges such as poverty, food insecurity and infrastructure deficits, the reforms have laid a foundation for long-term inclusive growth and economic resilience.



¹ Our Dollar, Your Problem, Yale University Press 2025.

Colombia

Colombia has been running large fiscal deficits and has seen debt to GDP tweak higher over the past number of years. Last year alone, the fiscal deficit was near 5% with overall debt/GDP climbing to over 61%. However, we see opportunities in Colombia, as the popularity of President Petro has waned in recent years. According to recent polls, President Petro's approval rating has declined to 29%, even from a low base of 37% in April. We see his reelection as unlikely and see growing hopes for regime change to a more fiscally sound government. Furthermore, while debt levels have risen, they are still manageable, particularly in light of the healthy FX reserve base which sits at roughly 15% of GDP.

Colombia remains a strong potential growth story given a diversified export base (oil, coal, coffee, gold) and a strong internally driven consumption economy, and a deep and healthy banking system has continued to extend credit penetration to less economically advantaged sectors. Furthermore, the current account balance improved from near a 6% deficit to near only a 2% deficit. The improvement has remained constructive for the economy and supportive of the Colombian peso. The unlocking of additional potential value rests in greater fiscal discipline allowing for greater confidence from foreign investors to deploy capital in key mining and agricultural sectors.

Brazil

According to recent news reported poll results, President Lula's approval rating sits below 50% with disapproval rating greater than 50%.

Similar to Colombia, we see political transition as key to the stabilization of fiscal spending and the increase in foreign direct investment (FDI) flows to Brazil. A strong fiscal anchor can help alleviate inflation concerns and allow the central bank to resume an accommodative stance for economic growth. This in turn can attract key foreign investment inflows.

While political transition may accelerate the drivers of FDI, we must note the strong internal checks and balances that exist in Brazil. There has been inertia in the legislature preventing more aggressive spending packages, and the central bank has been independent and resolute in maintaining high rates to tame inflation despite pressure from the central government to lower rates to both spur economic and alleviate the interest burden of the federal budget (currently interest expense adds nearly 6% to the annual fiscal deficit).

The checks and balances in Brazil, the independence and credibility of the central bank and the hope of political transition currently add a luster to the Brazil story.

Figure 4: EM countries are on a transition from double deficits to surpluses (5-yr avg.)



Sources: Haver Analytics, Federated Hermes as of 12/31/24
United States (US) and United Kingdom (UK) are developed markets. All others shown are emerging markets.

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ICE U.S. Dollar Index (DXY) measures the value of the US dollar against a basket of currencies of the top six trading partners of the US, as measured in 1973: the Euro zone, Japan, the United Kingdom, Canada, Sweden, and Switzerland.

MSCI Emerging Markets Currency Index measures the total return of emerging market currencies relative to a base currency, typically the dollar, euro or Japanese yen. It reflects both currency appreciation/depreciation and interest earned on those currencies. The index weights each currency based on its corresponding country's weight in the MSCI Emerging Markets Index.

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Indexes are unmanaged and cannot be invested in directly.

Current account balance is flows of goods, services, primary income and secondary income between residents and nonresidents of a given country.

Quantitative easing is the process of a central bank purchasing government securities from the market in order to lower interest rates and increase money supply.

Consumer Price Index (CPI) is a measure of inflation at the retail level.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Forward-looking statements or projections are subject to certain risks and uncertainties. Actual results may differ from those expressed or implied.

Past performance is no guarantee of future results.

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Diversification does not assure a profit nor protect against loss.

Prices of emerging-market and frontier-market securities can be significantly more volatile than the prices of securities in developed countries, and currency risk and political risks are accentuated in emerging markets.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

High yield, lower-rated securities generally entail greater market, credit/default and liquidity risks, and may be more volatile than investment-grade securities.

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