

The Merits of Emerging Market Sovereign Bonds

Comparing Hard and Local Currency Debt

August 2025





Increasing concerns about the deterioration in a number – but not all – developed world government balance sheets, together with increasing concerns about so called "fiscal dominance" over monetary policy has encouraged investors to reconsider the composition of their fixed income portfolios and look at emerging markets (EM) in a new light. We at Colchester have argued for some time that relative balance sheet strength, sustained adherence to policy orthodoxy, the shift to predominately domestic funding and the potential return on offer in a number of emerging markets has increasingly made them attractive relative to their developed world counterparts and other sectors of the fixed income market. However not all "emerging markets" are alike. Today, many investors and commentators still apply the blanket term "emerging markets" to loosely define all those countries not in the "developed world". In our opinion this is a misnomer. It is no longer appropriate to throw solidly investment grade countries like the Czech Republic, Poland or Chile into the same bucket as below investment grade countries like Pakistan, Venezuela or Uganda. Today the former, and others, are more like a number of traditional developed markets, while the latter are Frontier Markets possessing characteristics similar to the "emerging markets" of the 1980's and 1990's that spawned the "Tequila Crisis", "Asian Crisis", and other shocks that investors associate with emerging markets. In many respects, today's Frontier markets are the emerging markets of yesteryear.

It should be apparent that much like the difference between investment grade corporates and high yield in credit space, there is similar differentiation within emerging markets. Broadly speaking the emerging market fixed income universe can be divided into exposure to debt issued in local currency and that issued in hard currency, predominately US dollars.

Investors may access either:

- (i) the higher quality investment grade end of the local market spectrum, and/or
- (ii) local currency bonds in the frontier space, via separate dedicated local currency benchmarks.

On the other hand, the hard currency benchmarks tend to group all emerging markets into one encompassing AA countries at one end, to single C rated ones at the other end of the credit rating spectrum. Unsurprisingly the structural characteristics of the countries comprising each benchmark, their credit quality, and potential risk and return all differ across the three alternatives – EM local, Frontier local, and Hard Currency EM. Focusing on EM local and EM hard currency government debt we explore these differences, consider their potential role within a diversified policy mix, and assess current valuations in this paper.

The Role of Emerging Market Debt in a Diversified Portfolio

All investors, to varying degrees, need to balance and trade off three objectives, namely safety, liquidity, and return. Their particular circumstances, objectives and risk tolerance will each play a key role in the asset allocation decision of where to invest. For example, in the case of a central bank or reserve manager, liquidity and safety are likely to be paramount so domestic and global developed market debt are likely to form the core of their portfolio. However, other asset classes have historically offered higher return potential and thus may also find a place in the asset allocation, taking account of their safety and liquidity characteristics. Other investors such as endowments, foundations or superannuation funds may place a higher weight on expected long term returns, but likewise some allocation to relatively safe and liquid assets is likely to improve the overall risk-return characteristics of their portfolios. Whilst the most basic asset allocation decision between equities and bonds remains core to portfolio construction today, investors also consider a wide variety of other asset classes from property, to emerging market debt, to private equity and private credit.



Each asset class increasingly needs to compete with others to fulfil a certain role within the overall aggregate portfolio. Asset allocators are increasingly becoming aware that the diversification and potential risk and return characteristics of EM debt makes it a potentially interesting addition to their aggregate portfolio mix. Local currency EM debt may not only compete against investment grade corporates and high yield for space in that portfolio but also is increasingly being considered as a dedicated allocation in place of some traditional developed market (DM) fixed income exposure given its credit rating, relative balance sheet strength and return potential. In contrast, given its predominately US dollar orientation and lower credit quality, hard currency EM debt typically competes with High Yield and other higher risk or total return orientated sectors for space in an aggregate portfolio. Whilst some still fall into the trap of deeming local and hard currency EM as the same, the underlying characteristics, credit quality and currency exposure suggest that they are not.

Whilst a clear case can be made to treat both local and hard currency EM debt differently, many still compare the two as alternatives. Accordingly, any discussion needs to assess the respective merits of both. With that in mind, Colchester believes that local currency EM government debt is particularly attractive today for both strategic asset allocation (in terms of capital preservation, liquidity and return), and tactical (it offers attractive valuations at this juncture) reasons. In contrast, while hard currency EM sovereign debt has historically generated attractive returns, its characteristics are less conducive to the objectives of safety (i.e. capital preservation) and liquidity, given its lower credit ratings and poorer liquidity. Furthermore, in our opinion, current valuations of the hard currency EM debt asset class are less attractive than those prevailing in local currency space. This is in part due to the current overvaluation of the US dollar that those hard currency bonds are denominated in.

Table 1. Long-term asset class returns (31 Dec 2002 – 31 Dec 2024)¹

	Annualised Return	Annualised Volatility
Global Equities	9.30%	15.14%
US High Yield debt	7.37%	8.81%
Hard Currency EM debt	6.49%	8.74%
Local Currency EM debt	4.89%	11.60%
US Corporate debt	4.26%	6.28%
Local Currency EM debt (USD hedged)	3.72%	4.40%
Global Investment Grade (IG) Government debt (USD hedged)	3.08%	3.59%
US Treasuries	2.60%	4.66%
Global Investment Grade (IG) Government debt	2.23%	6.87%

Source: Bloomberg. Returns in USD unhedged terms unless stated otherwise.

Note: the start date of 31 Dec 2002 is chosen as this is the inception date of the local currency EM index.

¹ MSCI World Net Total Return USD Index, Intercontinental Exchange (ICE) Bank of America (BofA) US Cash Pay High Yield Index, JP Morgan Emerging Market Bond Index (EMBI) Global Diversified, JP Morgan Global Bond Index – Emerging Market Global Diversified (GBI-EM), ICE BofA Corporate Index, FTSE World Government Bond Index (WGBI), FTSE US Global Bond Index (GBI).



Historical Returns and Correlations

Historically both EM hard and local currency debt (unhedged in USD) have generated meaningfully higher returns than traditional defensive fixed income assets such as US Treasuries, albeit with higher volatility (see Table 1). The local currency asset class has comfortably outperformed US Treasuries, global developed market government debt, and US corporate debt since the inception of the standard index for local currency EM debt at the end of 2002. Hard currency debt has performed even better over this time period, albeit generating smaller returns than that of high yield corporate debt. Unsurprisingly, unhedged local currency EM debt returns with a historical volatility of 11.6% has been more volatile than hard currency EM debt (8.7%). This is primarily a function of its non-Dollar currency exposure and exchange rate movements. The volatility of local currency debt in USD-hedged terms at 4.4% has been meaningfully below that of hard currency debt. The volatility of local currency EM debt when hedged into US dollars had the second lowest volatility over the period amongst the asset classes we examined in Table 1, furthermore in US dollar hedged terms the asset class has the best risk adjusted returns.

The relevance of volatility per se depends on the objective and risk tolerance of the individual investor. For most investors the risk of permanent loss is probably more important than simply price volatility. As noted above, hard currency debt contains more outright credit risk than local currency debt and therefore exposes investors to a higher probability of default. That credit risk needs to be traded off against the potential return.

As well as the return profile, the relationship or correlation between different fixed income sectors - and therefore potential diversification benefits - should also be considered at the aggregate portfolio level. Table 2 suggests the diversification benefits of local currency EM debt are superior to that of hard currency EM debt, given its historically lower correlation to US Treasuries, investment grade corporate, and high yield corporate debt. Given the intrinsic characteristics of the two EM debt asset classes, this result is to be expected. Hard currency bonds are typically held by global investors and are valued and priced by the market as a credit spread relative to/over the US Treasury curve (as USD-denominated debt comprises the majority of this asset class). Local currency EM bond markets on the other hand, are typically bought by domestic investors and are therefore less sensitive to changes in global financial conditions and more sensitive to domestic economic conditions.

Table 2. Historical return correlations of fixed income sectors (31/12/2014 – 31/12/2024)²

	US Treasuries	Local Currency EM	Hard Currency EM	US IG Corporate	US High Yield
US Treasuries	1.00				
Local Currency EM	0.31	1.00			
Hard Currency EM	0.44	0.82	1.00		
US IG Corporate	0.73	0.66	0.86	1.00	
US High Yield	0.21	0.67	0.84	0.73	1.00

Source: Bloomberg. Returns in USD terms (unhedged for local currency EM debt).

Whilst it is important to understand historical returns and correlation behaviour, historical performance is not necessarily indicative of future performance. The returns generated from investment in any asset can be heavily dependent on the valuation of the asset class in question at the outset. The starting point matters. The back up in yields in response to the post-COVID inflation shock has seen interest rates in all fixed income sectors broadly reset at higher levels, more in line with historical norms. While investors are once again being "paid" to own bonds, the relative attractiveness of different sectors varies.

² FTSE US GBI, JP Morgan GBI-EM Global Diversified Index, JP Morgan EMBI Global Diversified Index, ICE BofA Corporate Index, ICE BofA US Cash Pay High Yield Index.



Most notably credit spreads have fallen to multi-year lows in the likes of the US, UK and Europe in the third quarter of 2025. This suggests that some caution may be warranted in those sectors that are priced as a spread relative to the underlying sovereign. That includes corporate debt, high yield and EM hard currency debt. Some of those sectors historical absolute and relative performance reflects the spread compression that has occurred, and the relative strength of the US dollar compared to the non-US assets that comprise a larger proportion of the global indices and local currency EM debt indices presented in Table 1. A reversal of either of these drivers is likely to have a significant impact on relative returns going forward.

As noted above asset allocators not only need to consider potential returns. They also need to consider capital preservation, credit ratings and liquidity.

1) Capital Preservation and Liquidity

Starting with the safety, or capital preservation, characteristics of local and hard currency EM debt:

Default Probability

Table 3 shows the historical default rates over the last 50 years of EM sovereign debt in both local and foreign currency, and by credit rating.

Table 3. Sovereign Cumulative 5yr Average Default Rates (1975-2024)

Rating	Foreign Currency	Local Currency
AAA	0.00	0.00
AA	0.00	0.00
A	1.09	1.04
BBB	2.44	1.28
BB	3.74	2.04
B	17.36	8.35
CCC/CC	49.23	33.08

Source: Default, Transition and Recovery: 2024 Annual Sovereign Default and Rating Transition Study, Standard and Poor's, 2025.

Local currency debt has had a lower default rate across the board. Intuitively we would have expected this. Sovereign issuers typically have the unique ability to create ("print") the currency of denomination of the bond, as well as an ability to raise taxes from their domestic economies to meet financing and servicing needs. Governments also face pressure from their local population, who vote, or implicitly have the power to remove those in government. It is therefore not surprising that, as most local currency EM debt is held domestically, there is a greater willingness to default on foreign rather than domestic creditors at a point of stress. These factors make hard currency EM debt more vulnerable to default, and the historical experience bears this out.

When examining defaults and exploring why foreign currency defaults are so much higher, it is probably worth considering why governments issue debt in a foreign currency. As an individual if you were to borrow money, say to purchase a house, you would earn money in your local currency, buy the house in your local currency, and you would almost undoubtedly borrow the money in your local currency. Borrowing money in a foreign currency might enable you to obtain a lower interest rate, but you would also take on the risk that the exchange rate could move, and this risk will nearly always be much higher than any saving on the interest rate could justify. The same is true for governments; by borrowing in a foreign currency, they are taking on substantial currency risk, so why would they do this?



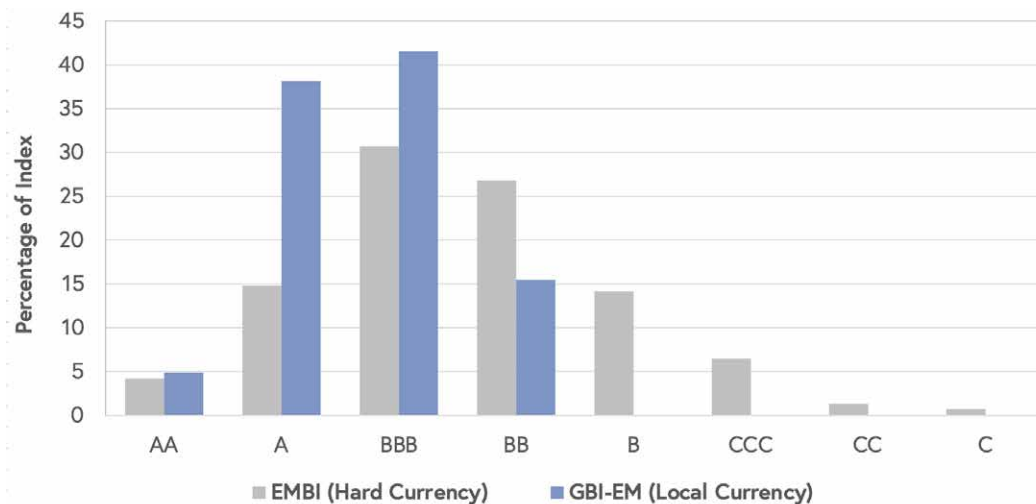
The emerging markets universe is made up of two types of countries, those that have a "natural" hedge against foreign currency risk, and those that do not. For example, Saudi Arabia and Qatar are in the EM hard currency index and borrow in US dollars. Both countries have pegged their currencies to the US dollar as their main exports, oil and gas, are priced in US dollars. They may have borrowed in Dollars, but they also have a "natural hedge" as the majority of their revenue is directly linked to the US dollar. On the other hand, there are countries like Argentina and Egypt that borrow in US dollars. They fall into the second category as these countries have little in the way of a natural hedge. So why do they do it?

Essentially the answer is that in a country where the financial system is not very developed, the government often struggles to raise the necessary finance that it needs domestically. This means it is forced to borrow from international investors, and they often want to lend in US dollars. Once a country has borrowed in a foreign currency, they are vulnerable to large currency moves where their domestic currency falls against the US dollar. When this happens, it reduces their ability to repay their foreign debt. Historically, when a country has defaulted on its foreign debt it has often been preceded by a steep fall in the value of the domestic currency. Normally there are other fundamental problems in the country that may contribute to the weakness in the currency, but it is the currency devaluation that typically forces the default.

2) Credit rating

Given this higher default probability on hard currency EM debt, asset allocators need to be aware of the different rating profiles of both EM fixed income sectors when comparing the two. Not only is the probability of default lower in local currency debt, the credit rating of the standard local currency EM index (JP Morgan GBI-EM Global Diversified) has a demonstrably higher rating profile than its hard currency counterpart (JP Morgan EMBI Global Diversified). This difference is clear in Chart 1. The higher credit ratings enjoyed by local currency debt is not surprising as economies with more stable currencies and inflation, as well as deeper domestic capital markets, tend to issue more debt domestically rather than in hard currency in international markets. Many of those countries included in the local currency index issue around 90% of their debt in local currency. By issuing in their local currency, default risk is reduced, and this is rewarded by the credit rating agencies with higher ratings. Chart 1 clearly shows that the vast majority of the local currency index - some 85% - is currently rated investment grade³. Whereas the hard currency index has only 49.7% at the investment grade level and a "tail" of lowly rated countries in the index. This is where the credit rating and default probability intersects.

Chart 1. Credit Rating Profile of Local and Hard Currency Indices⁴



Source: JP Morgan, Bloomberg. As of August 2025.

³ As at end August 2025.

⁴ The rating shown is the highest of S&P, Moody's and Fitch, where available. The local currency rating is used for the JP Morgan GBI-EM Global Diversified (GBI-EM) and the foreign currency rating for the JP Morgan EMBI Global Diversified (EMBI).



3) Liquidity

Liquidity is the final characteristic asset allocators need to consider. When we compare the depth and liquidity of each market, we observe that the local currency universe is significantly larger and more liquid. Currently, the market value of EM local currency government debt is estimated by JP Morgan to be around USD13 trillion, whereas the stock of hard currency debt is estimated at only USD1.5 trillion⁵. This large and widening discrepancy is not surprising as countries have an incentive to reduce their external vulnerability by developing local capital markets and issuing in domestic currency. This reduces their exposure to external shocks, the risk of a capital flight and a potential shortage of foreign currency to meet funding needs. The three largest issuers of government debt within the EM universe - China, India and Brazil - each issue more than 90% of their government's debt in local currency.

As EM countries increase their income levels and governance standards, they issue local government debt and foreign investors typically enter their market. This leads to an increase in the potential investable universe and improves liquidity. Once a country's local currency yield curve is fully developed and the appropriate bond settlement practices are setup index providers would typically then consider them for inclusion in relevant benchmarks. When this happens, demand and the liquidity profile typically increase. The inclusion of India in the local currency JPM GBI-EM index in 2024 is a good example of this evolution (see Box).

Unsurprisingly given the larger issuance in local currency there is greater liquidity and lower bid-ask spreads in the local, compared with hard currency EM debt markets. For example, in our experience, weighted average bid-ask spreads in the local currency universe are around 0.30 (as a percent of price) whereas they are around twice that in the hard currency investment universe⁶. Furthermore, there is a tendency for dealing costs to increase more in the hard currency universe at times of stress. For example, spreads widened more in hard currency space at the time of the so-called "Liberation Day" shock in the US in April 2025. Some may find this surprising, but for those countries that have developed their own capital markets and encouraged a savings industry, the risk-free asset for domestic investors is their own government bonds. It follows that the risk-free asset for a Thai or Mexican pension fund is not the US Treasury but rather is Thai or Mexican government bonds issued in their local currency respectively. The consequent intrinsic demand for these securities underwrites the local market, provides liquidity and keeps bid-ask spreads in check.

The Inclusion of India in the JPM GBI-EM Global Diversified Index

In 2024, India was included in the local currency EM government bond index, adding the fifth largest economy in the world to the benchmark. This added further liquidity to the local currency market as foreign investors were drawn into the market. It also enhanced the investment grade characteristics of the benchmark as India was BBB- rated at the time by the three main rating agencies⁷. India's weight in the index built up from a small initial percentage at inclusion in June of 2024 and is now at its full 10% weight in the benchmark⁸. This now means that six out of the twenty largest economies in the world are now in the JP Morgan GBI-EM global diversified index. Saudi Arabia is also looking to be included in the local index. Should that occur, it would take the number to seven.

Not only does India add another large economy to the index, but it also adds to the diversification within the index. The Indian market not only has a low correlation with developed bond markets and risk assets, but it also has a comparatively low correlation with other countries in the EM universe. Over the last ten years to the end of 2024 the correlation of Indian bonds hedged into US dollars with US Treasuries was only 0.34, whilst their correlation with US high yield was only 0.07.

⁵ JP Morgan as at end of December 2024.

⁶ As at the end of December 2024.

⁷ India was subsequently upgraded to BBB by Standard & Poor's on 14 August 2025.

⁸ As at August 2025.



The table below shows the correlation of Indian bonds with other major bond markets in the local currency index, as well as with the aggregated index itself. It is readily apparent that historical correlations have been low across the board. This suggests the addition of India probably increased diversification within the index and enhanced the opportunity set for active managers like Colchester to potentially generate alpha.

Table 4. Correlation Between INR denominated Indian Government Bonds and Other Local Currency Bond Markets

	India	Brazil	Mexico	Indonesia	Thailand	Poland	China	Türkiye	Colombia	Malaysia	GBI-EM
India	1.00										
Brazil	0.24	1.00									
Mexico	0.25	0.36	1.00								
Indonesia	0.21	0.42	0.56	1.00							
Thailand	0.36	0.36	0.66	0.47	1.00						
Poland	0.31	0.13	0.52	0.34	0.55	1.00					
China	0.21	0.10	0.13	0.03	0.32	0.10	1.00				
Türkiye	0.07	0.25	0.19	0.30	0.21	0.05	0.04	1.00			
Colombia	0.28	0.46	0.57	0.53	0.52	0.44	0.02	0.15	1.00		
Malaysia	0.20	0.32	0.59	0.51	0.73	0.54	0.27	0.02	0.40	1.00	
GBI-EM	0.14	0.54	0.63	0.71	0.57	0.38	0.02	0.27	0.63	0.54	1.00

Source: JP Morgan, Colchester Global Investors. Returns are in USD-hedged terms and for the 10 years to end December 2024.

Relative Valuations: Hard versus Local Currency

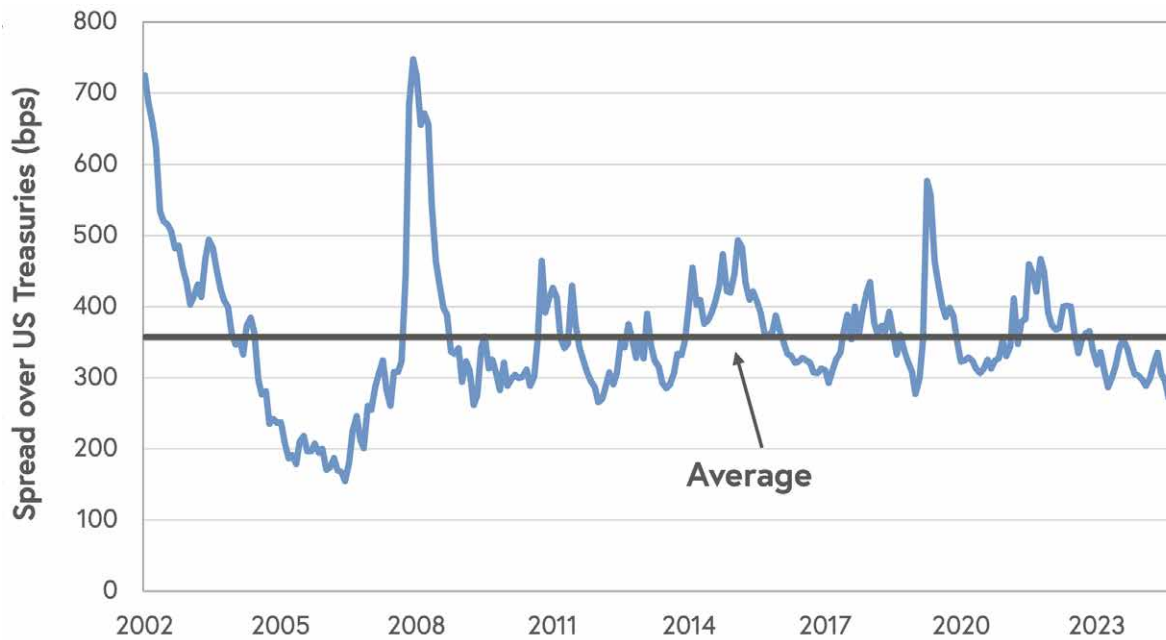
The structural characteristics of an asset class need to be balanced with the valuation on offer when considering the merits, or otherwise, of its inclusion in the overall portfolio asset allocation mix.

When valuing hard currency EM debt there are two components that make up the valuation. As most of these bonds are issued in US dollars and priced against US Treasuries, the first component is the valuation of the underlying US Treasury bond. Of course, an investor can gain access to the US Treasury market without buying emerging market debt, so the component that really matters is the yield spread versus the government curve of the currency of issuance, and this is the primary valuation metric. As noted above, as most hard currency debt is issued in US dollars, the spread is typically assessed versus the underlying US Treasury curve. Chart 2 shows the spread of the EMBI index over US Treasuries since December 2002.⁹ The spread has averaged 357 basis points over this entire period and remarkably even if one ignores the swings in the spread associated with the mid 2000's valuation bubble that saw the spread fall to a low of around 150 basis points in mid-2007, and the subsequent rebound as the that bubble burst, the spread averaged 356 basis points in the post Global Financial Crisis (GFC) period from the end of 2010 to the end of August 2025. In other words, if one ignores this outsized volatility in the spread, the average is essentially the same. In this context, it is perhaps surprising to see today's spread pushing the lower bounds of the last 15 years or so when the global growth outlook is particularly clouded given the potential negative impact of US tariffs, the likely resulting dislocation in supply chains and uncertain inflation and interest rate outlook. Such an environment has not always been positive for lowly rated borrower's dependent on foreign capital. Whilst the same argument could be made about spreads and valuations across a range of credit sectors today, this suggests to us at least, that some caution is warranted in EM hard currency space - *history suggests valuations are on the expensive side.*

⁹ This is the commencement date of the equivalent JP Morgan Global Diversified Local currency index.



Chart 2. JP Morgan EMBI Global Diversified Index Spread and Average Level, December 2002 to end August 2025



Source: JP Morgan, Bloomberg, Colchester Global Investors. Month end data from December 2002 to August 2025. Please note the "spread" is over US Treasuries.

US Dollar

The second factor that must be taken into account by asset allocators when looking at the value of hard versus local currency EM debt is the starting value of the US dollar. The strength or otherwise of the US dollar will impact on relative returns. Whilst hard currency returns in US dollars are unaffected by the movement in the Dollar (as that is the currency the underlying asset/bond is denominated in), local currency returns in US dollars will fluctuate inversely in relation to the movement in the Dollar. US dollar strength implies local currency weakness and hence lower Dollar returns for those assets denominated in non-US dollars, and vice a versa. Relative returns between the two EM debt classes will therefore be significantly impacted by the movement in the US dollar. Whilst we discuss this in more depth below, the upswing in and sustained strength of the US dollar over the past 10 years or so has certainly been a factor in the historical performance differential between local and hard currency EM debt observed over that period (Table 1). The current valuation of the Dollar therefore matters in any assessment of potential future returns. Should the Dollar decline, local currency EM debt may be expected to outperform (all else being equal) and conversely underperform hard currency EM debt if the Dollar strengthens from here. Hence the Dollar's current valuation matters.

Towards that end, the primary driver of our currency valuation framework at Colchester is the real exchange rate, along with a view on the strength of a country's balance sheet, its' institutions, governance and other ESG factors, and the differential in short term real interest rates. Notwithstanding its fall from its recent highs at the turn of the year, our valuation framework suggests the US dollar remains meaningfully overvalued as at the end of August 2025. If the Dollar continues to fall from here, it is reasonable to expect the currencies comprising the EM universe will (on average) appreciate versus the Dollar, boosting relative returns of assets denominated in those currencies. It follows that the "relative" tailwind that has favoured hard currency EM debt over the last decade would turn into a headwind as assets in non-US dollars outperform.



While the fall in the US dollar would not affect the value of hard currency EM investments in US dollar terms for a Dollar based investor, they would not be able to take advantage of the fall in the US dollar. In other words, there is a potential opportunity cost in investing in hard currency EM when the Dollar is at over-valued levels. Not all is lost however, as a fall in the value of the US dollar is likely to also benefit the hard currency index as a weakening Dollar would, all things being equal, make it easier to repay Dollar debt, relieving some pressure on those lower rated credits. However, with spreads already "tight" relative to history, the improvement in spread is likely to be only marginal.

Local Currency Valuations

Turning to local currency EM debt. Colchester's investment framework breaks down the inherent value in local bond markets into two parts. For the bonds the primary driver of our valuation is the prospective real (i.e. inflation adjusted) yield. Then as we are buying those bonds in their local currencies, we also value the currency.

Starting with the bond valuations, historically, bond markets in those countries with higher relative real yields have generated better returns than those with lower real yields. Accordingly, after adjusting for the robustness, or otherwise, of a country's balance sheet, and the strength and quality of governance and other ESG factors, we are drawn to countries with higher (adjusted) real yields. As the future ex-post real yield is unknown, we focus on the outlook for inflation to determine our estimates of ex-ante or prospective real yields on offer.

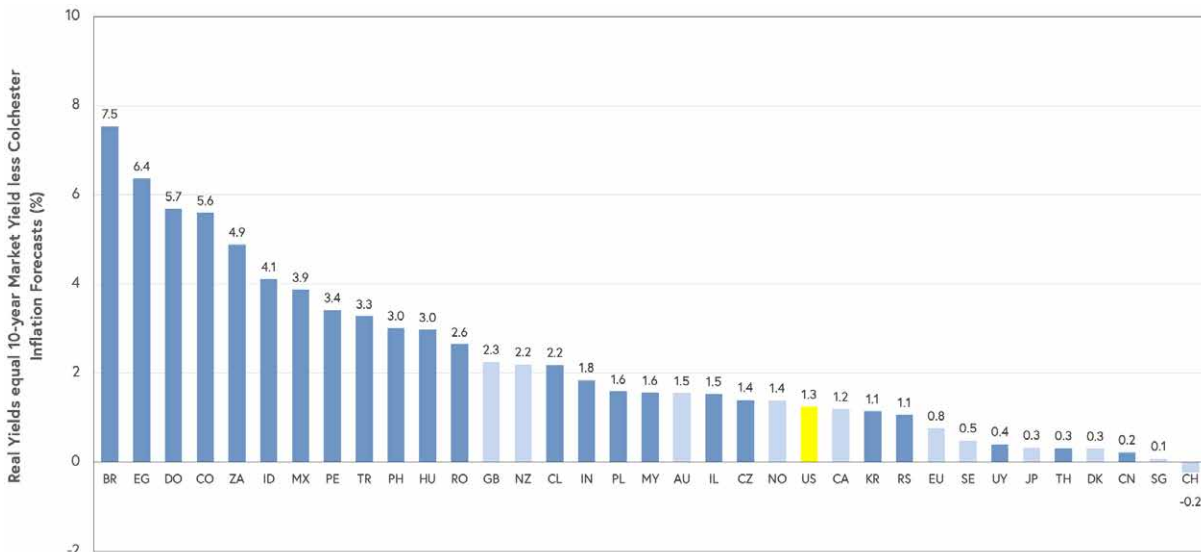
Towards this end, inflation in the emerging world was buffeted over the last 3 to 4 years by the same supply and demand shocks that the developed world was exposed to. Like elsewhere, there was a surge in inflation in response to the post-pandemic supply chain disruption, the subsequent demand shock driven by aggressive stimulus, and elevated food and energy prices. Latin America and Central Europe were particularly hard hit, while the experience in Asia was more mixed¹⁰. As global inflation pressures have receded, inflation has declined in a number of emerging markets at a similar, if not faster pace, than that seen in the developed markets. Most notably the likes of Mexico, Indonesia and South Africa have all experienced significant declines to comparatively low levels as inflation was brought under control.

Although the future inflation picture has been complicated by the US tariff situation, real interest rates remain high in a number of EM countries compared to those in the developed world. This makes those markets more attractive in both absolute terms and relative to their developed world counterparties, including the US bond market. This can be seen in Chart 3 showing Colchester's prospective real yield estimates as at the end of August 2025. It is evident that a diversified basket of EM bonds could be constructed comfortably offering a 4% prospective real yield, in contrast to the 1% to 1.5% on offer in the developed world. All else being the same this suggests EM bonds have greater potential to generate higher returns going forward than those in the DM universe.

¹⁰ Inflation topped 25% in Hungary and rose to around 18% in Poland and the Czech Republic. The likes of Colombia, Brazil and Chile fared a little better, peaking somewhere between 12% and 14%, while Mexican inflation peaked in line with the US at around 9%. In contrast, Indian inflation hardly deviated from its norms, Chinese inflation peaked at 3% and Indonesian and South Korean inflation peaked around 6%. In comparison, Australian and Canadian inflation peaked around 8%, Swedish around 12%, the UK 11%, the Eurozone 10%, Norway and New Zealand 7%, and Japan 4%. Source: Bloomberg, inflation data measured between April 2022 and August 2025.



Chart 3. Prospective Real Yields on Offer in the Emerging and Developed World as of August 2025



AU	Australia	CZ	Czech Republic	ID	Indonesia	NO	Norway	SE	Sweden
BR	Brazil	DK	Denmark	IL	Israel	NZ	New Zealand	SG	Singapore
CA	Canada	DO	Dominican Republic	IN	India	PE	Peru	TH	Thailand
CH	Switzerland	EG	Egypt	JP	Japan	PH	Philippines	TR	Turkiye
CL	Chile	EU	Eurozone	KR	South Korea	PL	Poland	US	United States
CN	China	GB	United Kingdom	MX	Mexico	RO	Romania	UY	Uruguay
CO	Colombia	HU	Hungary	MY	Malaysia	RS	Serbia	ZA	South Africa

Notes: 1. The prospective real yield for the 10 year sector is shown here for representational purposes. Colchester values up the 2, 5, 10 and 20 year sectors of the yield curve when valuing a country. The final portfolio reflects the value on offer in these individual yield curve points. 2. The expected real yield for Euroland is calculated based on the 10 year German Bund yield and the Colchester forecast for inflation in the Eurozone. 3.Source: Colchester Global Investors, individual Central Bank CPI and PPI data, and Bloomberg.

The second potential driver of returns is the currency element. As discussed above, if the basket of currencies associated with the foreign assets held (in this case EM bonds and currencies) is expected to appreciate against the US dollar then this provides a further structural tailwind for returns in the emerging market bond asset class¹¹. The converse also holds true. When assessing EM currency valuations against the US dollar, it is therefore useful to consider where the Dollar currently is in the valuation cycle. If the Dollar is overvalued and expected to decline over the medium term, then this will, all other things being equal, improve the return potential of local currency emerging bonds/currencies.

Since the inception of the EM local currency debt index, there have been three distinct episodes in the US dollar:

- 1) the depreciation in the first seven to eight years of this century,
- 2) the major appreciation that took place from 2011 to 2022 (even though this extended upward trend in the Dollar did see periods of weakness in 2017 and 2020) followed by a further post covid lift, and
- 3) a period of consolidation over 2008-2011 (See Chart 4)

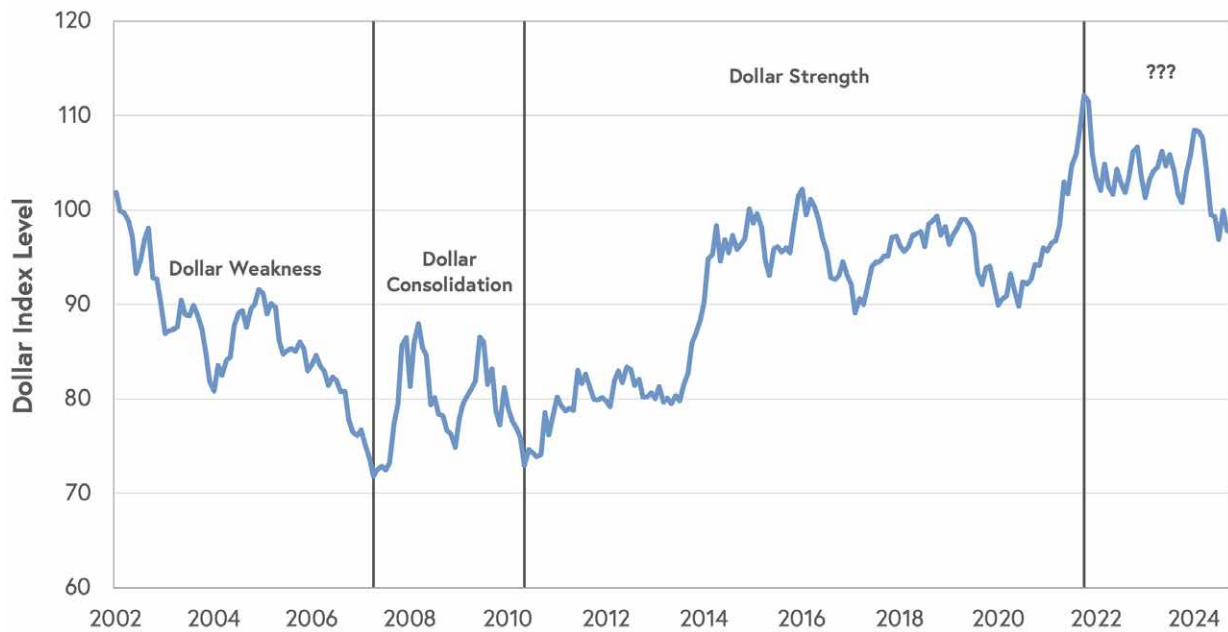
To determine the current valuation of the US dollar, as noted above, we turn to an assessment of the real exchange rate. Historically this has proved to be a useful metric with which to assess the relative value of currencies over the medium term and underpins our currency valuation framework at Colchester. Our current assessment of the real value of the US dollar suggests that it may have peaked in the second half of 2022 and may now be at the beginning of another cycle of US dollar

¹¹ If all foreign assets are hedged back into the domestic currency, then the potential for positive or negative currency returns is negated.



depreciation, similar to that seen in the early 2000's. Colchester estimates that the US dollar reached an overvaluation in real terms of close to 30% against an equally weighted basket of five major developed world currencies¹² in late 2022. Whilst the US dollar has weakened a bit since then, it has remained at extremely overvalued levels throughout 2024 and into 2025 according to our real exchange rate analysis. Assuming, as the weight of historical evidence suggests, this super-cycle in the US dollar is likely drawing to a close, and the probability of a retracement back towards fair value is increasing, then this is likely to impact favourably on EM local currency returns going forward.

Chart 4: Cycles in US Dollar Exchange Rate



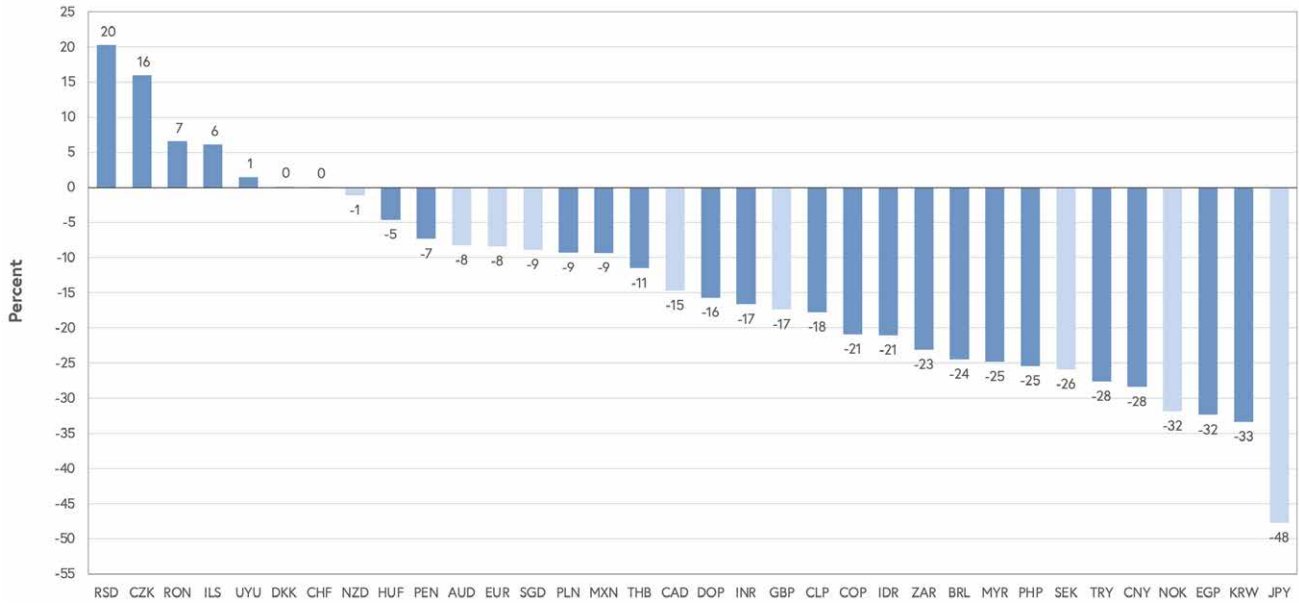
Source: Dollar Index from Bloomberg, Colchester Global Investors. Data from December 2002 to end August 2025.

Chart 5 shows real exchange rate estimates for both developed and emerging world currencies as at the end of August 2025. An equally weighted basket of EM currencies is undervalued relative to the US dollar by almost 12% in real terms. This suggests EM currencies are more likely than not to appreciate against the US dollar over the medium term, providing a potential return tailwind for unhedged US dollar EM denominated assets. At the very least it suggests that any positive bond returns, being delivered by the higher real and nominal yields on offer on the bond side of the EM local currency debt asset class, are unlikely to be eroded by EM currency weakness over the medium term. Of course, a US dollar-based investor would be able to gain from a fall in the US dollar by holding non-Dollar assets, but what is especially attractive about local EM bonds is that the underlying asset - the bonds - in our opinion are also attractively valued.

¹² The Euro, British pound, Japanese yen, Canadian dollar, and Norwegian krone.



Chart 5: Real Exchange Estimates Versus US Dollar as at end August 2025



AUD	Australian Dollar	CZK	Czech Koruna	IDR	Indonesian Rupiah	NOK	Norwegian Krone	SEK	Swedish Krona
BRL	Brazilian Real	DKK	Danish Krone	ILS	Israeli New Shekel	NZD	New Zealand Dollar	SGD	Singapore Dollar
CAD	Canadian Dollar	DOP	Dominican Peso	INR	Indian Rupee	PEN	Peruvian Sol	THB	Thai Baht
CHF	Swiss Franc	EGP	Egyptian Pound	JPY	Japanese Yen	PHP	Philippine Peso	TRY	Turkish Lira
CLP	Chilean Peso	EUR	Euro	KRW	Korean Won	PLN	Polish Zloty	UYU	Uruguayan Peso
CNY	Chinese Yuan	GBP	British Pound	MXN	Mexican Peso	RON	Romanian Leu	ZAR	South African Rand
COP	Colombian Peso	HUF	Hungarian Forint	MYR	Malaysian Ringgit	RSD	Serbian Dinar		

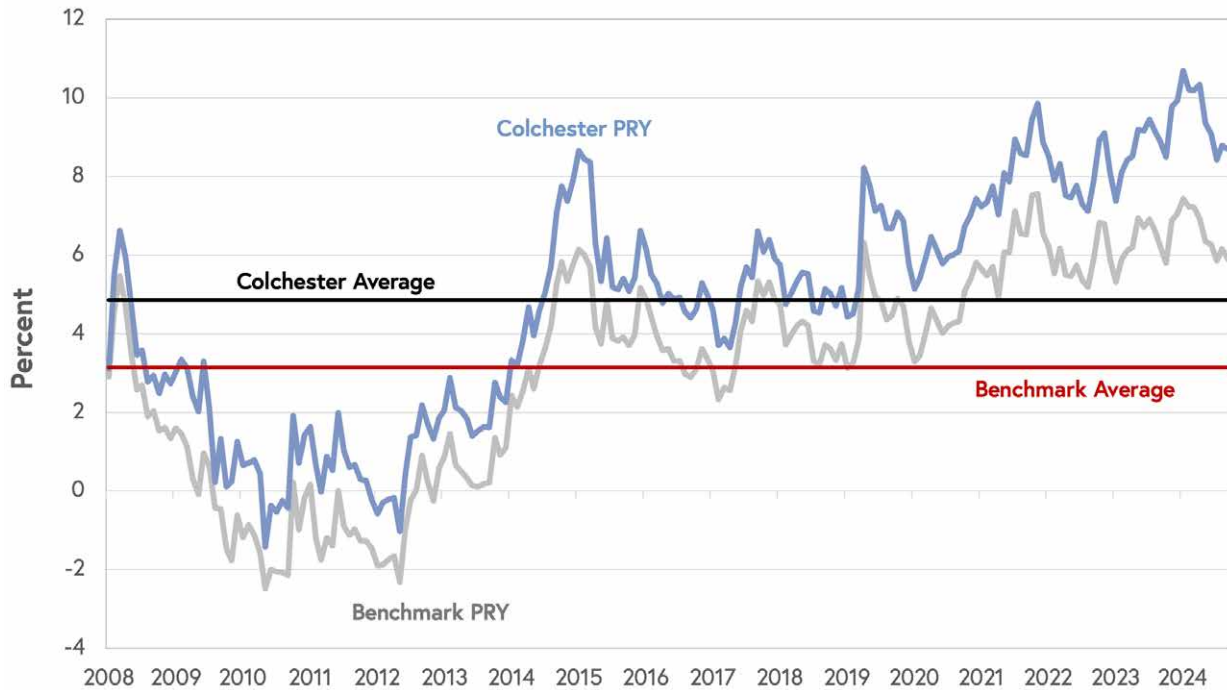
Source: Colchester Global Investors, individual Central Bank CPI and PPI data, Bloomberg and WMR.

Chart 6 shows a combined valuation metric for the local currency EM bond index (the JP Morgan GBI-EM Global Diversified) and for Colchester's portfolio over time. The bond element is simply the weighted average prospective real yield. In other words, the nominal yields in each market adjusted for Colchester's forecast of future inflation. The currency element is the weighted percentage over or under-valuation in real terms relative to the US dollar, divided by -5.¹³ The over- or under-valuation is estimated by calculating the real exchange rate for the currency and comparing that to a measure of long-term equilibrium or "fair value".

Combining today's bond and currency valuations in Chart 6 suggests that local currency EM debt is attractively valued compared to history. Whilst not at its highest observed valuation point, it is close to the best value we have seen since Colchester launched our EM local currency debt program in 2008, and the intrinsic real value on offer today compares favourably to history. We estimate the value on offer is almost an equal split between EM bonds and currencies.

¹³ The historical evidence suggests on average there is a 5 year mean reversion process. Accordingly, by dividing by -5 we translate the over or under valuation into an average expected change in the exchange rate. For example, if a currency is 10% undervalued relative to the USD, we translate that into a positive exchange rate change expectation of 2% (i.e. -10%/-5).

Chart 6. Combined Bond and Currency PRY Valuations



Source: JP Morgan, Bloomberg, Colchester Global Investors. Data from December 2008 to August 2025. Black and red lines show the respective averages over the period.

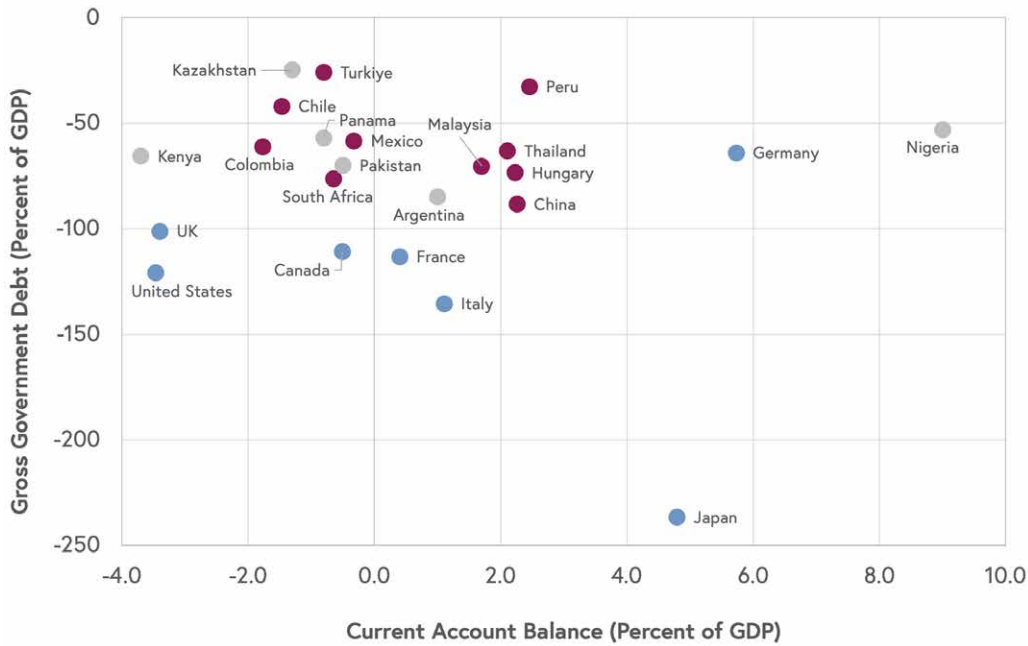
Balance Sheet Considerations

Finally, investors need to consider whether their investments are money good, or will they get repaid. Towards that end, we at Colchester evaluate the strength of a country's fiscal balance sheet and related factors to assess both the value on offer in their bond market and to determine the sustainability of their debt and deficit profile. An assessment of the external balance sheet also highlights any vulnerabilities that may pressure the currency.

Overall, the local currency bond universe has stronger fundamentals than many developed world counterparties. A simple aggregated measure combining both a country's government debt level and current account provides a useful insight into its overall balance sheet strength. The level of government debt provides an insight into a country's historical fiscal profligacy or prudence, its capacity to cushion shocks and its ability to repay its debt. Similarly, the current account provides insight into a country's ability to fund itself, the need for foreign capital and the accumulation of foreign liabilities. While there are many dimensions and layers to assessing the strength or otherwise of a country's balance sheet, Chart 7 provides a useful snapshot. It shows these two measures plotted on a scatter graph for a selection of major countries in the local currency emerging market index, some in the hard currency index, and the G7 countries.



Chart 7: Gross Government Debt Against Current Account Position



Source: IMF, Colchester Global Investors. Data as of 2024.

The local emerging market countries are shown in red, and they tend to be towards the top of the chart, which means that they are relatively less indebted. The grey countries are some of those that are in the hard currency EM index and have broadly a similar picture. Only Germany of the developed countries has comparable government debt levels to many in the EM world, with the other developed world countries having significantly higher debt levels. The current account position is slightly more nuanced with most EM countries generally within a +/-2% band, Frontier countries tending to run larger deficits (given their need for capital at this stage of their development) and G7 countries showing considerable dispersion with the US and the UK in particular consuming notably more than they make relative to the rest of the world.

These conclusions are consistent with the patterns we have seen emerge since the GFC. Namely less fiscal prudence and policy orthodoxy in the developed world relative to the EM world, leading to a faster build-up of debt in those countries. This has translated into structurally better balance sheets in the EM relative to those in the DM world. Within our investment framework this improves the relative value of EM versus DM markets as relative balance sheet strength provides them with greater capacity to withstand and cushion shocks like the 2025 tariff shock currently rolling across the globe. This enhances the real yield (or PRY) advantage discussed above and reduces the likelihood of balance sheet issues undermining any potential currency appreciation gains should the US dollar continue its descent. Euro high yield returns are heavily influenced by Eurozone interest rate movements, resulting in higher cross-correlations among its constituents. Conversely, EM local currency debt benefits from greater diversification, driven by low cross-country correlations. These arise from varying inflation dynamics, monetary policy responses, and economic cycles across emerging markets, further enhanced by the distinct drivers of returns between a country's bond and currency markets.



Conclusion

To conclude, we believe that asset allocators need to weigh up the return, liquidity and safety characteristics of different asset classes. Local and hard currency EM government debt both offer attractive historical returns, and diversification benefits relative to core fixed income but should also be considered distinct asset classes. Local currency EM debt in our opinion offers structurally higher liquidity and lower credit risk for the reasons outlined in this paper. The diversification benefits are also somewhat better, and the investment grade nature of the asset class is increasingly seeing it compete with investment grade corporates, and at the margin DM debt, for space in diversified aggregate portfolios. Global factors tend to have more of an influence on hard currency debt markets while domestic drivers tend to impact more on local currency debt markets.

In our opinion, the cyclical outlook currently favours local currency EM debt. Hard currency debt and other credit sectors currently have low yield spreads relative to history, while valuations in local bond markets look attractive, especially when combined with the US dollar's current fundamental overvaluation against most global currencies. Should the US dollar continue to adjust back towards fair value this should provide a significant return tailwind for local currency EM debt going forward. Similarly, the structural improvements in a number of emerging market countries balance sheets over the last couple of decades has been reflected in notable improvements in credit ratings in the sector. This has significantly improved their attractiveness relative to a number of developed world economies where government balance sheets are increasingly looking stretched, and policy constrained. These EM markets no longer exhibit the historical characteristics of emerging markets, Frontier Markets are better thought of as those markets today.

In summary, we believe the attractive real yields on offer, meaningful currency undervaluation against the US dollar and relative balance sheet strength all make local currency emerging market debt an attractive proposition in the current environment.



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