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Emerging markets in a fragmented world: From geography to resilience - the 4Rs framework

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In Summary

- **The Iran war marked the first major oil shock that did not trigger a broad emerging markets sell-off.** Markets repriced countries based on strengths and weaknesses rather than the traditional EM–DM divide. This supports a resilience-based investment framework built around the "4Rs" – Resource Position, Reserve Strength, Rate Credibility and Refinancing Structure – which increasingly explains cross-country differentiation more effectively. Although institutional mandates, benchmarks and trading-desk structures will continue to rely on the EM–DM distinction for the foreseeable future, portfolio construction frameworks that lean primarily on this historical classification risk becoming progressively less relevant.
- **Resource Position, not the EM–DM label, defines the fault line of the Iran shock**. Economies with large import dependencies such as Egypt, Romania, South Korea, Greece and the UK, have faced the strongest repricing pressures, while commodity exporters have benefited from improved terms of trade. Even in a downside scenario with oil prices above USD180/bbl, the pain would be concentrated within the energy-importing cohort.
- **Reserve Strength increasingly separates resilient sovereigns from vulnerable "triple-deficit" economies, irrespective of EM or DM classification.** Since the 2013 taper tantrum, many EMs have rebuilt fiscal discipline, strengthened current-account positions and stabilized debt trajectories, entering the Iran shock with roughly 1pp of GDP more fiscal headroom than at the onset of Covid-19. EM economies now account for roughly 60% of global GDP in PPP terms, up from around 40% in 2000. FX reserve buffers have continued to strengthen across the Middle East, Central Asia and Emerging Europe, while several advanced economies remain mired in persistent fiscal deficits and deteriorating external balances.
- **Rate Credibility has structurally improved across EMs and increasingly resembles DM-style monetary frameworks.** Inflation targeting is now the norm across most major EMs, and EM central banks tightened by an average of 780bps during the post-pandemic cycle versus around 400bps in the DM, frontloading hikes despite weaker growth. The Iran war has confirmed this convergence: no major EM central bank has been forced into emergency hikes, capital controls or disorderly stabilization. EM FX volatility has fallen materially, with several G10 currencies experiencing higher volatility during 2024–25. Outliers, notably Türkiye, Argentina and Nigeria, remain, but the broader convergence trend is intact.
- **Refinancing Structure has fundamentally changed the transmission of external shocks.** Foreign-currency debt shares have fallen by roughly 20–40pps across major countries including Brazil, Mexico, India, Indonesia and several CEE. Deeper domestic institutional investor bases and larger local-currency bond markets have reduced vulnerability to USD and Fed, turning FX depreciation into a macroeconomic adjustment mechanism rather than a solvency trigger. Currently, EM currencies adjusted in an orderly manner with no widespread defaults or emergency IMF interventions; even in a downside scenario of further Fed and ECB tightening, the likely outcome is slower convergence rather than a return to a crisis like the 1990s or early 2010s.
- **The compression of EM risk premia increasingly reflects structural convergence rather than cyclical overvaluation.** The excess spread of EM hard-currency debt over comparable DM credit has largely disappeared on a rating-adjusted basis. Even in a downside Iran escalation scenario, EM hard-currency spreads would likely widen from around 178bps to approximately 235bps and peak near 280bps, materially below the roughly 700bps reached during the Covid-19 shock. A compelling long-term case increasingly lies in EM local-currency debt, where structurally higher real yields continue to generate superior long-term risk-adjusted returns relative to DM fixed income.

The line between EMs and DMs is blurring

Emerging vs. developed is not a label – it is an investment hypothesis about institutions, policy credibility and the distribution of tail risks that is being tested by the fragmentation of the global economy. The traditional EM–DM split has been a shorthand for differences in the strength of institutions, the predictability of policymaking and the degree to which investors can trust rules to be stable over time. These institutional features matter because they shape inflation outcomes, fiscal discipline, market depth and, ultimately, the risk premium investors demand. Importantly, recent market experience has also highlighted that DM does not automatically mean risk-free: volatility in some developed government bond markets has risen materially since 2022, and fiscal uncertainty has become a more visible driver of term premia and curve behavior. In parallel, a structural fragmentation of the global economy, the US-China decoupling, the partial US retreat from its role as anchor of the rules-based order, friendshoring, supply-chain regionalization and growing regulatory divergence across blocs, has begun to redistribute risk away from the EM-DM axis and toward country-specific positioning within a contested international system. The two forces compound each other: DM credibility is eroding from within just as the global architecture that historically rewarded DM positioning is being rewritten from the outside.

Introducing the 4R framework: a resilience-based alternative to EM–DM

Throughout this paper we organize the analysis around four structural dimensions that explain cross-country market segmentation better than the EM–DM taxonomy:

- Resource Position: energy dependence, commodity exposure, vulnerability to terms-of-trade shocks such as the Iran war
- Reserve Strength: fiscal discipline, external balances, FX reserves, exposure to twin or triple deficits
- Rate Credibility: central bank independence, inflation-targeting frameworks, convergence of monetary policy reaction functions
- Refinancing Structure: local-currency funding shares, depth of domestic investor bases, resilience to USD and Fed cycles

The subsequent analysis maps the evidence onto these four dimensions of the "4Rs" framework.

A large and growing share of EM debt trades on fundamentals that increasingly resemble DM-style underwriting like credible central banks, improving external buffers and solid policy frameworks while EM risk dynamics improve. Parts of the DM universe display EM-like stress points through political constraints and fiscal slippage. The fragmenting global economic system reinforces this EM-DM convergence, as several EMs are positioned to benefit from ongoing supply-chain and trade realignments while parts of the DMs see their competitive positions deteriorating. In parallel, dispersion across countries remains high, meaning "EM beta" is less informative than identifying where fundamentals warrant investment-grade-like pricing and where high-yield-like tail risks still dominate.

A conceptual difference appears in EM sovereign debt. EM hard currency government bonds are, by construction, a spread asset because default/restructuring risk is non-zero and must be priced. DM government bonds, in contrast, are – just like EM local currency sovereign bonds – typically treated as the benchmark "risk-free" curve in their own currency. A significant change in a country's economic and political outlook is first and foremost digested on FX markets. Investors should recognize that term premia can still move meaningfully with inflation uncertainty, fiscal outlook and market functioning, even absent classical default risk. For portfolio construction, the practical takeaway is that investors should separate spread risk from rate, term-premium and FX risk, and to avoid relying on labels when the underlying risk drivers have shifted.

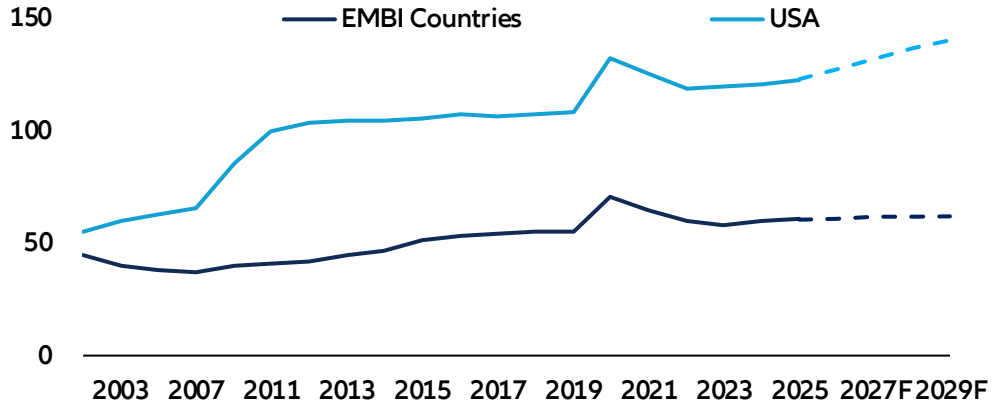
Improved fundamentals: fiscal discipline, external position

This section examines the first two Rs — Resource Position and Reserve Strength. The current shock is the latest data point in a deeper structural shift: the distinction between developed and emerging markets is blurring. Political instability, rising populism and unsustainable public finances were traditionally associated with EM

countries, but they have become descriptions for some of the world's largest and most 'developed' economies in recent years. While each country's political backstory is unique, the common theme is a pronounced deterioration of macroeconomic fundamentals – a dynamic that global fragmentation increasingly reinforces as weakening institutions and fracturing trade relationships feed on each other in a self-reinforcing spiral. Today, glaring fiscal imbalances in the US and other 'advanced' economies point to an inversion of the traditional world order, with little prospect of a meaningful reversal.

In strong contrast to their DM peers, EMs have seen strengthening fundamentals over the past decade. Spurred by the upheaval of the 2013 taper tantrum, which exposed underlying economic imbalances, many EMs have undergone significant rebalancing, strengthening their resilience. Even after the Covid-19 pandemic took hold, many EM policymakers remained fiscally prudent, resulting in primary fiscal balances returning to surplus within just a few years and debt-to-GDP stabilizing at modest levels, improved external positions across EM sovereigns and stronger growth outlooks for EMs compared to DM peers.

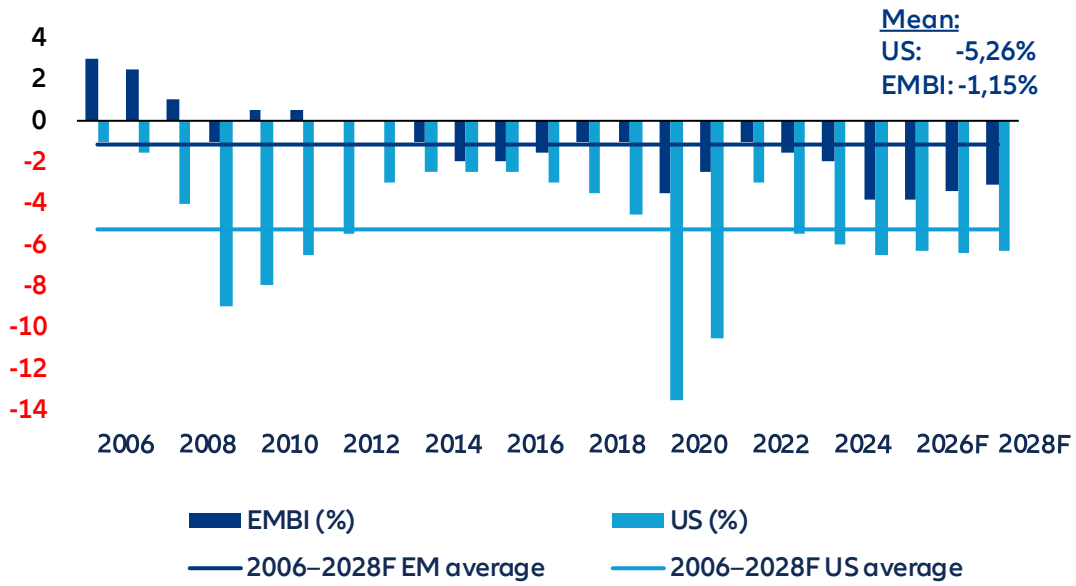
Figure 1: General government gross debt, EMBI countries and US, 2003–2029F (% of GDP)



Note: Dashed lines indicate IMF/Bloomberg forecasts.
Sources: IMF, Bloomberg (forecasts), Allianz Research

The Iran war is a live test of Reserve Strength. The early evidence suggests EMs have entered the shock with more headroom (1pp of GDP) than the Covid-19 shock overall. However, this aggregate masks a wide dispersion in fiscal positions, from those that experienced forced reforms in recent years due to shocks and cyclical beneficiaries to those deteriorating. The successive shocks of Covid-19, the Ukraine war and the 2022–23 inflation surge functioned as a stress test that catalyzed reform in two distinct cohorts of improvers. Pakistan, Ghana and Romania were forced into adjustment by near-default conditions and IMF programs, with Argentina also in this group given Milei's dramatic primary surplus delivery in 2024–25. Colombia, Brazil and to a more ambiguous extent Mexico are in the second cohort, having improved through commodity tailwinds and limited tariff exposure. On the deteriorating side, Indonesia, Thailand, Bangladesh, Hungary and Nigeria have each seen pronounced erosion since 2020, driven respectively by subsidy expansion, fiscal stimulus, political transition costs, pre-election spending and oil-revenue volatility.

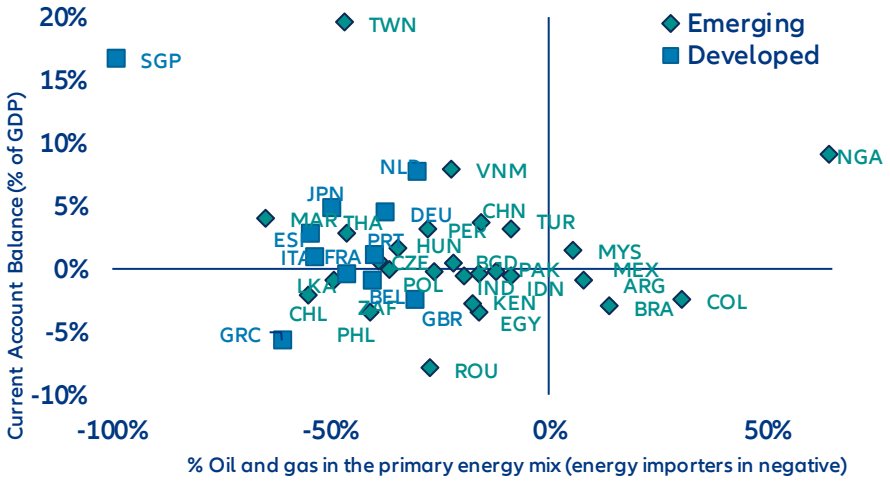
Figure 2: General government fiscal balance, EMBI countries and US, 2006–2028F (% of GDP)



Note: Horizontal lines show period averages (2006–2028F).
Sources: IMF, Bloomberg (forecasts), Allianz Research

The Iran war shock has revived the severity of global imbalances, but the differentiation it has produced is not between EM and DM – it runs along Resource Position, separating energy importers from exporters. In prior decades, an external shock of this magnitude would have triggered a near-mechanical sell-off of EM assets against developed-market safe havens, with the EM-DM dividing line acting as the primary axis of risk repricing. The 2026 episode has yet to produce such pattern. Those countries more exposed to the ongoing war are those EMs and DMs with current account deficits and large imports of hydrocarbons, which include countries such as Romania, Egypt, as well as the UK or Greece. If the conflict escalates further, this distinction would sharpen rather than dissolve: in a downside scenario of sustained supply shortages and oil prices spiking above USD180 per barrel, averaging close to USD100 for 2026, the most acute repricing would fall on this energy-importing, current-account-deficit cohort rather than on EMs as a whole. The remaining group would still experience a sell-off, but a materially reduced one, consistent with the broader resilience indicators discussed throughout this section. Even in a severe escalation, in other words, the dividing line would run through energy exposure, not through the conventional EM-DM taxonomy.

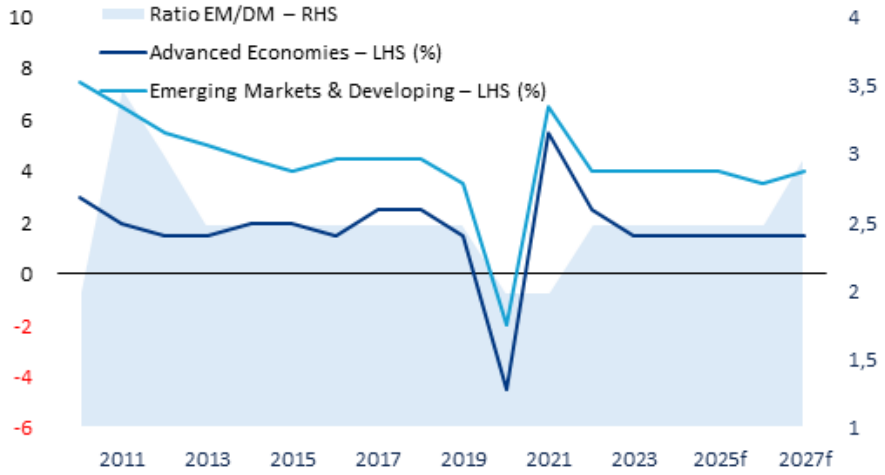
Figure 3: Heterogenous current account imbalances, but EMs better positioned with regards to energy independence than DMs



Sources: LSEG, Allianz Research

EM growth continues to outperform that of DMs, and the relative growth differentials are expected to widen further, continuing to reweight EMs at the center of the global economy. Emerging and developing economies now account for roughly 60% of global GDP in purchasing-power-parity terms, up from approximately 40% in 2000, a 20pps reallocation of global economic weight. The growth trajectory indicates a widening distance between EMs and DMs, causing a further acceleration of the EM catch up towards DM purchasing power levels. In addition, the Iran war shock has not disrupted this trajectory. Hence, the center of gravity of the global economy will continue to move towards the EM bloc in the years to come.

Figure 4: GDP growth, advanced economies and emerging markets & developing markets, 2011–2027F (% y/y)

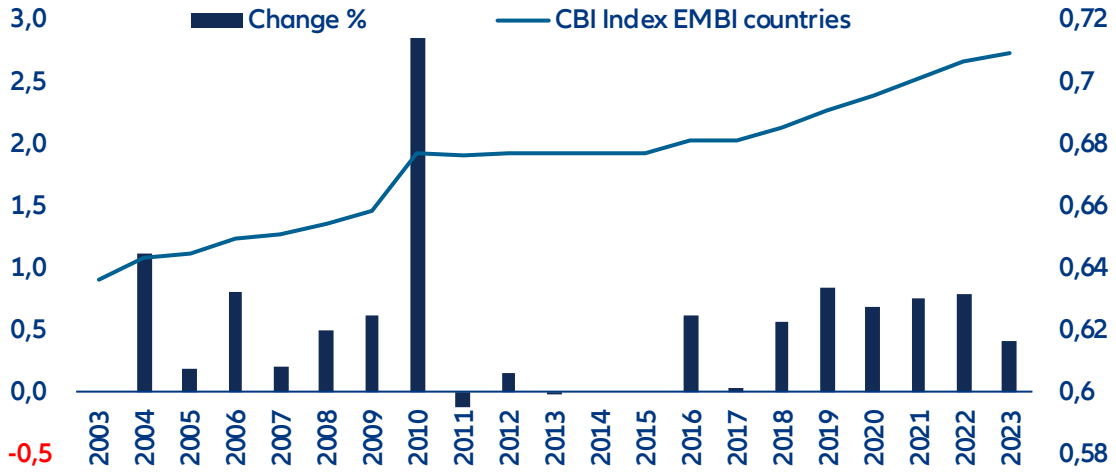


Note: . Shaded area shows the EM/DM growth ratio (RHS).
Sources: IMF, Bloomberg (forecasts), Allianz Research

Monetary policy convergence: evidence and implications

The third R – Rate Credibility – captures three decades of EM progress on central bank independence and policy frameworks, accelerated by the GFC and pandemic shocks, although regions and income levels diverge. As shown in Figure 5, the most pronounced increase in central bank independence among EMBI countries occurred in the aftermath of the GFC, and while the index plateaued temporarily in the subsequent years, it resumed a continuous upward trajectory from 2016 onward. The upper-middle-income group (which captures most of the "core" emerging markets: Brazil, Mexico, South Africa, Malaysia, Thailand etc.) shows the most consistent upward trend, narrowing the gap with high-income countries throughout the 1990s–2010s. While Latin America remains ahead and the closest to DM convergence, MENA (with the exception of Israel) remains the laggard region. Eastern and Central Europe experienced a dramatic catch-up wave tied to EU accession. While low-income and low-middle income countries have experienced the quickest convergence towards DM standards in the last 15 years, the reforms undertaken by West Africa Economic and Monetary Union (WAEMU) countries sharply improved Africa's convergence, though it remains uneven. These reforms include central bank mandates covering everything from board composition, governor appointment rules and limits on lending to the government to financial and budgetary independence, reflecting a structural rather in how EM central banks are designed to operate. Overall convergence is being driven by regional integration (experienced in the EU and WAEMU), external inducements especially tied to IMF-induced reforms, given the conditionality of IMF programs on central bank independence, as well as crisis and shocks that trigger reforms.

Figure 5: Central Bank Independence (CBI) Index for Emerging Market Bond Index (EMBI) countries



Note: The line depicts the Central Bank Independence (CBI) Index, a weighted composite of six sub-dimensions (board independence, policy autonomy, policy objectives, lending restrictions, financial independence, and reporting requirements), scaled from 0 (no independence) to 1 (full independence). Bars show the year-on-year change in percentage points.
Source: CBI Database

Inflation targeting frameworks are the new normal. Twenty years ago, most EM central banks managed exchange rates or monetary aggregates. Today, South Africa, Brazil, Mexico, Chile, Colombia, India, Indonesia, Philippines, Thailand, Türkiye (nominally), Egypt (post-2024 reform), Ghana, Kenya and others run explicit inflation-targeting regimes with published targets, forecasts and forward guidance. The South Africa Reserve Bank is the latest to shift from a 3–6% range to a 3% point target, in itself a convergence move towards DM-style inflation anchoring. EM central banks tightened by an average of 780bps during the post-pandemic cycle, versus around 400bps in advanced economies, a decisive demonstration of improved policy credibility.

The Iran war also serves as a live test of increased EM central bank credibility and EM-DM monetary policy convergence. So far, no major EM central bank has been forced into emergency hikes, capital controls or disorderly stabilization measures, a significant break from the historical pattern of oil shocks triggering balance-of-payments crises across EM economies. The differentiation once again runs through fundamentals rather than the EM-DM label. In a downside scenario of further escalation, this resilience would be tested but not overturned: sustained energy-price pressure would likely prompt the Fed to deliver two further 25bp hikes and the ECB three, tightening global liquidity and raising refinancing costs for sovereigns with larger hard-currency debt loads. Crucially, even this tightening would be milder than the cumulative policy response seen during the Covid-19 and Ukraine-war inflation episodes, and its impact would be more contained. Hard-currency debt now represents a materially smaller share of total EM sovereign debt than in previous shock episodes, limiting the mechanical transmission of tighter global liquidity into EM balance sheets. In other words, the downside scenario would slow the convergence but not reverse it.

Increased orthodox monetary policy has reduced the inflation risk premium embedded in currencies, reducing volatility self-reinforcing the investor base. As inflation-targeting regimes have matured and central-bank independence has been entrenched, the inflation risk premium embedded in EM exchange rates has fallen. Lower pass-through reflects anchored inflation expectations, which in turn reduce the volatility and tail-risk character that historically defined EM FX as an asset class. During 2024/25, EM FX volatility was overtaken by G10 FX moves due to several parallel moves: the yen's performance, Trump's tariffs announcements and EM strength. The 2026 Iran war episode has provided new evidence: EM currencies have adjusted to the oil shock through orderly depreciation rather than crisis-style breaks, EMBI+ spreads have remained contained and no EM central bank has been forced into emergency hikes or capital controls, a stark contrast to the chaotic EM responses of 1973 or 1997.

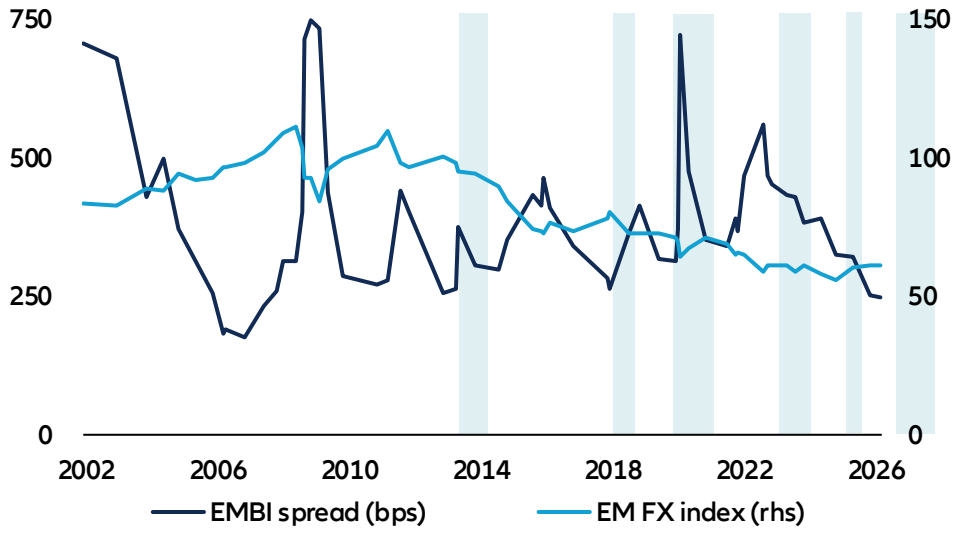
While the convergence has been taking place, a gap remains between EMs and DMs due to more government interference in key countries, market perception, as well as several outliers undermining the average. The convergence thesis is supported by the median EM central bank, but relevant central banks of the EM asset class, such as China or India, operate with higher government influence or within distinct frameworks. Meanwhile, a

meaningful tail of outliers continues to undermine the unweighted average, such as Türkiye (the 2021–23 unorthodox episode under political pressure, with credibility now being rebuilt), Argentina (whose monetary regime debate goes beyond central bank framework questions), and Nigeria (where multiple FX windows and "stealth tightening" remain in place despite Governor Cardoso's reform agenda). Egypt and Pakistan are mid-transition cases where IMF programs have catalyzed reform but track records are short. Notably, Brazil, often cited as a test case given the government pressures on the central bank, has emerged as a convergence success as political pressure did not prevent the September 2024 reversal back into hikes.

Shock absorption and resilience in EMs

This section turns to the fourth R – Refinancing Structure – alongside the broader shock-absorption toolkit. The structural fragility that has historically defined EMs, including exposure to external shocks, dollar funding and commodity volatility, has paradoxically become the foundation of their resilience. Repeated stress events over the past two decades forced EMs to adopt institutional and structural reforms and the evidence is visible in market behavior itself. EM hard-currency (HC) spread widenings firmly recovered after each crisis and show a level of resilience since the global rate hiking cycle triggered a sell-off in 2021-2022, which would have seemed unthinkable just a few years earlier (Figure 6). Even more astonishing is the stability in EM currencies. Previous crises like the GFC in 2008-2009 or the EM sell-off in 2015 triggered major losses in EM currencies, but since then EM currencies show a remarkable stability, as moderate FX losses typically fall short of the EM excess carry. The 2018 EM sell-off, the 2020 Covid-19 shock, the 2022 Ukraine-driven inflation surge and the 2026 Iran war have each tested and reinforced the asset class. Fundamental strengthening as well as larger and deeper shock absorbers like FX reserves levels, higher FX flexibility to absorb and lower level of HC debt are decreasing external vulnerabilities linked to the USD and the Fed.

Figure 6: EM hard-currency spreads and FX as stress indicators and recovery dynamics across major crisis episodes, 2002–2026

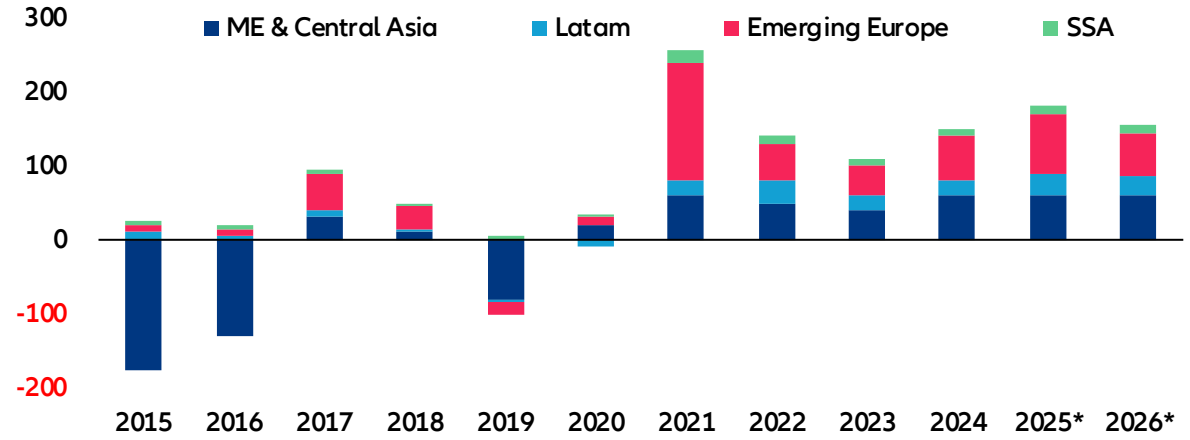


Note: The time series approximate the development of EM hard-currency spreads (JP Morgans flagship EMBI index) and EM FX (JP Morgan's EM currency basket EMCI) around major crisis affecting EM debt, namely the Global Financial Crisis 2008-2009, taper tantrum 2013, the EM sell-offs in 2015 and 2018, Covid-19 in 2020 as well as the global rate hiking cycle in 2021-2022. Intervals between major crisis events are smoothed for readability.
Sources: JPMorgan, Allianz Research

EM FX reserves have proven remarkably resilient over the long term, despite repeated bouts of external stress. As shown in Figure 7, aggregate reserve accumulation across EM regions turned sharply positive again after the pandemic-driven drawdown in 2019 and 2020, with the Middle East, Central Asia and Emerging Europe contributing to the bulk of inflows since 2021. While the pace of accumulation has moderated from its post-

pandemic peak, the structural trend remains constructive, with forecasts for 2025 and 2026 pointing to continued reserve building across most regions. Sub-Saharan Africa and Latam remain the most vulnerable in terms of reserve adequacy, but even here the direction of travel has improved relative to the acute stress periods of 2015 to 2016 and 2019. Taken together, the data suggests that EM reserve buffers are broadly stronger today than a decade ago, providing a meaningful cushion against external shocks, including the kind of energy-price and financing-condition volatility associated with the current geopolitical environment.

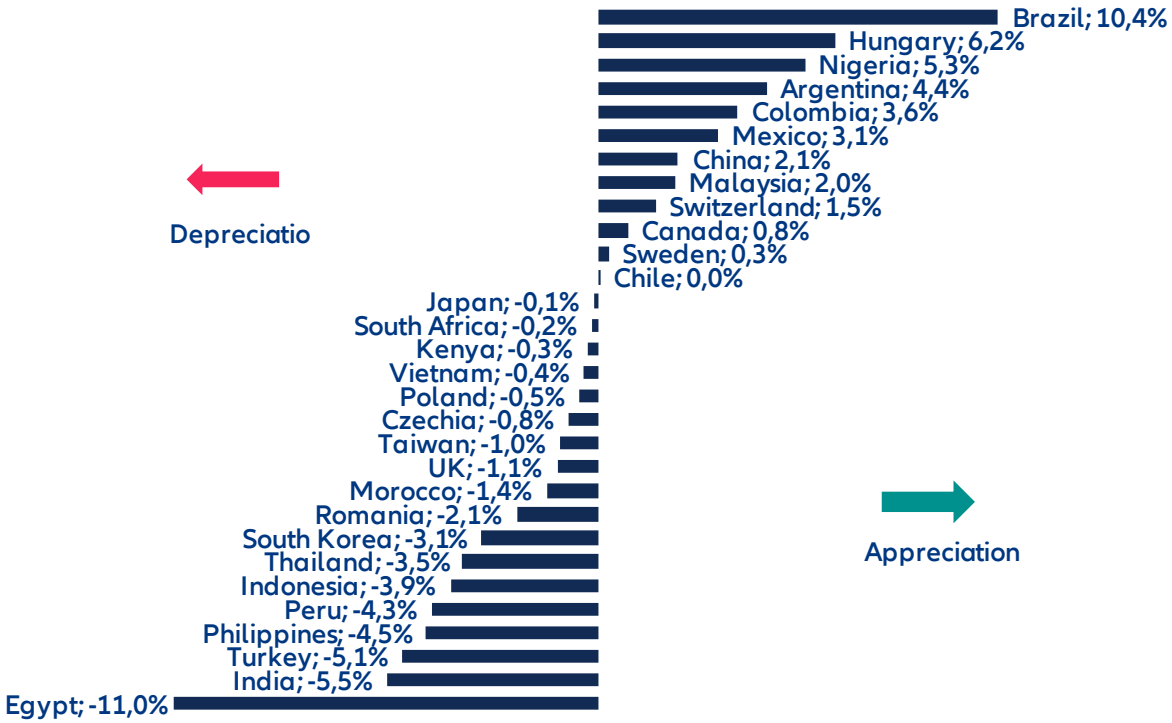
Figure 7: EM FX reserves by region, 2015–2026F (USD bn)



*Note: as of April 2025, *indicates forecasts.*
Source IMF, Bloomberg (forecasts), Allianz Research

Beyond reserve buffers, the broader shift toward flexible exchange rate regimes has been the second pillar of EM shock absorption, allowing currencies to function as adjustment mechanisms rather than crisis triggers as they often did in prior decades. The ongoing energy-linked shock is a great example. The dividing line between energy importers vs exporters, and exposure to Middle Eastern hydrocarbons, holds true in the currency space as well. The most exposed Asian countries have led the depreciation cycle since the start of the war, given their heavy exposure to Gulf energy imports, among them the South Korean won, together with other energy-importing countries such as Romania, Morocco or Türkiye. On the opposite side, energy exporters, many in the LATAM region, have benefited the most from the shock. Two notable outliers complete the picture: Hungary, where the post-election political transition has overridden the energy-trade signal, and China, whose low oil-import intensity and continued access to discounted Russian energy have largely insulated it from the shock. The Egyptian pound stands out as one of the worst-performing LCU, where pre-existing external imbalances have been compounded by geographic proximity to the conflict. Egypt is, however, also illustrative of a broader structural change: it is one of a cluster of historically crisis-prone EMs – alongside Ghana, Nigeria, Pakistan, Ethiopia and Sri Lanka – that have shifted from managed pegs and multiple exchange-rate windows toward market-determined floats since 2022, in most cases under IMF programs. This matters for the downside scenario. In previous shock episodes, these economies typically defended overvalued pegs until reserves were exhausted, at which point the currency broke and a balance-of-payments crisis followed. With more flexible regimes now in place, a further escalation of the energy shock would still produce a sharp depreciation in this cohort, but as a gradual adjustment rather than a sudden-stop rupture, with the currency absorbing the shock incrementally instead of triggering it. The contrast with the 1997 Asian crisis or Egypt's own pre-2024 experience is the clearest illustration of how regime choice has changed the character of EM shock transmission.

Figure 8: Currency performance 2026 YTD



Sources: LSEG, Allianz Research

Refinancing Structure has been transformed: EM sovereigns have shifted their funding mix from hard currency to local currency over the past two decades, with foreign-currency debt shares falling by 20–40pps across leading EMs. Brazil, Mexico, India, Indonesia, Thailand and the major CEE sovereigns now fund themselves predominantly in domestic currency, supported by deeper domestic institutional investor bases and growing foreign participation in local currency bond markets. The implication is structural: a stronger dollar no longer inflates EM debt burdens to the same extent as it did in 1997, 2013, or still in 2018. Local currency depreciation has become an adjustment mechanism rather than a solvency event which is the single most important reason the Iran war shock has so far been absorbed without disorderly defaults, capital controls or IMF emergency programs.

However, the USD continues to be a strong external influence on EM moves, causing central banks to be ahead of the Fed. Given that the USD anticipates Fed expectations, EM central banks across the board track the Fed. During the 2021–22 inflation surge, EM central banks in Brazil, Mexico, Chile, Czech Republic, Hungary and Poland tightened ahead of the Fed. That is a complete reversal of the historical pattern where EMs reacted defensively to Fed moves. In the subsequent easing cycle, they started to ease only after the Fed's easing cycle began in 2024. During the latest Iran war response, the monetary authorities of South Africa, Egypt and Israel all framed their pauses to monetary easing identically, referring to "inflation expectations anchoring" and "data dependence". No EM central bank has hiked aggressively nor imposed capital controls, in contrast with the 1973 or 1979 oil shocks, when EM responses were disordered and followed devaluations and defaults. This demonstrates the transition towards a converged reaction function: EM central banks now follow their own script anticipating the Fed rather than just acting in reaction to its moves.

What does this mean for EM debt investors?

The 4Rs framework has clear implications for portfolio construction, but the EM–DM taxonomy will not disappear from the investment universe overnight. Benchmark providers, institutional mandates and asset-manager desk structures (EM versus DM credit, EM versus DM rates) remain organized around the historical classification, and these institutional features will continue to shape how capital is allocated for the foreseeable future. With that caveat in mind, improving monetary and fiscal credibility together with an increasing capacity to absorb shocks – captured across all four Rs – reduces the downside of EM debt investments and changes their role in institutional portfolios. These structural improvements carry direct implications for portfolio construction. For risk-

constrained investors – pension funds, insurers, sovereign wealth funds – the historically cautious stance toward EM debt was grounded in real volatility: the "Fragile Five" of 2013, the "Troubled Ten" that followed, serial default cycles and the chronic vulnerability to Fed tightening. That era reflected genuine fragility. But as fiscal credibility improves, monetary frameworks mature and shock-absorption capacity deepens, the risk premium embedded in EM debt increasingly overstates actual portfolio risk. The practical consequence is meaningful: lower volatility and reduced tail risk justify higher EM debt allocations within existing risk budgets, without requiring investors to take on more aggregate portfolio risk. For liability-driven investors in particular, this is not a marginal shift – it represents a structural re-rating of an entire asset class, and portfolios that fail to reflect this new reality may be leaving risk-adjusted return on the table.

Despite the long-term improvement in EM fundamentals and the convergence with DMs, investors in EM hard-currency debt were historically paid a significant premium for "EM risk" over "DM risk". On a like-for-like basis across rating classes, EM hard-currency debt traded at a meaningful spread over comparable developed market bonds. This excess reflected genuine incremental risks, including thinner liquidity, greater sensitivity to dollar strength and commodity cycles, political instability, currency mismatch on sovereign balance sheets and a structurally narrower investor base that demanded compensation for volatility and sudden-stop risk. History vindicated some of that caution. The Tequila, Asian and Russian crises of the 1990s, Argentina's repeated defaults and the 2013 taper tantrum all demonstrated that EM spreads could widen sharply in ways investment-grade DM bonds rarely did. More recently, as convergence has progressed and EM fundamentals have matured, this structural risk premium has compressed (Figure 9). The excess spread of EM over DM credit has now largely disappeared, and relative valuations are broadly fair, with little incremental compensation remaining for investors crossing the EM/DM boundary. The compression of the premium does not, however, imply the disappearance of cyclical risk. In a downside scenario of further escalation in the Iran conflict, we assess that the average EM hard-currency spread would widen from its pre-crisis level of 178bps to around 235bps over 2026, with a peak of close to 280bps during the year. The scale of this move would be modest by historical standards. During the Covid-19 shock, the EMBI Global Diversified spread widened from roughly 300bps to a peak of around 700bps in March 2020, more than doubling in the space of weeks, before retracing over the following months. The downside repricing we envisage for the Iran scenario, by contrast, would represent a widening of around 100bps at its peak. This more contained response suggests that convergence has altered the nature of EM spread risk, rendering it more cyclical and less crisis-prone, without eliminating it entirely.

Figure 9: EM sovereign over US credit pick-up on a rating-adjusted basis

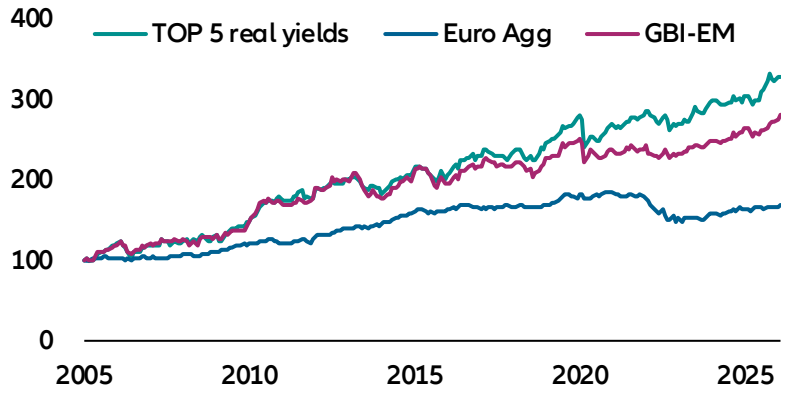
Notes: To calculate the pick-up Emerging Markets hard currency debt investors get for "EM risk" over "DM risk", we compare the spread over US Treasuries for EM Sovereign bonds (JP Morgan EMBIG) with the option-adjusted spread for US Credit (Bloomberg) per rating bucket (AA, A, BBB, BB, B). The pick-up reflects the weighted average of the spread difference based on rating bucket weights in the EMBIG.

Sources: JP Morgan, Allianz Research

An EM risk premium can still be earned when we move our focus from credit to rates. EM local currency bonds offer much higher nominal yields compared to DM bonds. From a DM-based investor's point of view, we have to take FX risk into account. There is a long history of EM currency depreciation against major DM currencies that exceeds 2% p.a. in a long-term average. Nevertheless, exposure to EM local currencies pays off as local excess carry exceeds FX losses in the long-term. The root cause of higher EM performance is the real yield pick-up. After accounting for the inflation embedded in higher nominal EM rates, EM local debt has historically offered real yields

that are substantially higher than what investors can earn in DM markets, where demographics, productivity slowdowns and central bank intervention have compressed real rates. This matters because real yields are not merely an academic construct: empirically, they are among the strongest predictors of long-term fixed income returns, capturing the true compensation investors receive for bearing interest rate risk. For a DM investor, that persistent real yield advantage is the genuine investment case for EM local currency debt. Not only did EM local currency bonds significantly outperform a Euro Aggregate investment over the past 20 years for a EUR-based investors; selecting the highest real yielders only further boosted EM local currency outperformance (Figure 10).

Figure 10: EM local currency debt outperforms DM fixed income for EUR-based investors, higher real rates are the major driver of the outperformance

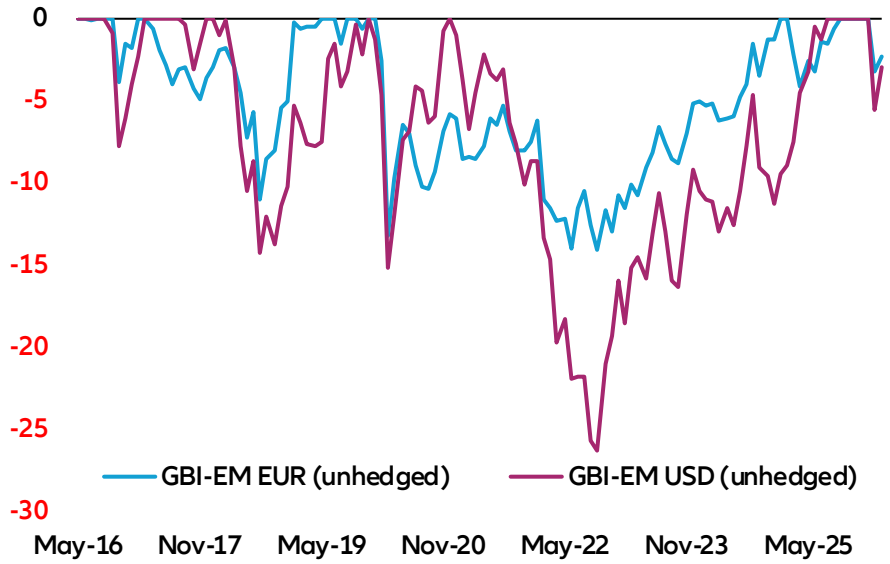


Notes: To analyze the importance of the real yield, we have tested a trading strategy that invests equal-weighted into five issuers offering the highest expected real yields of the GBI-EM investment universe, JP Morgans flagship EM local currency index. At each point in time, the expected real yield is derived by subtracting the inflation forecasts over the next 5 years from the 5yr nominal bond yield.

Sources: LSEG Workspace, Oxford Economics, Allianz Investment Management

While EM local currency FX clearly adds volatility to DM investors, EUR-based investors benefit from mitigation by their home currency. The carry of EM local currency cash is a strong performance contributor for DM-based investors, while FX is without doubt the strongest source of volatility. For a EUR-based investor, FX volatility looks meaningfully different and in some ways more favorable than it does through a USD lens. Because the USD functions as the world's reserve and safe-haven currency, other currencies tend to weaken against it in unison when global risk appetite deteriorates and investors seek shelter. The EUR is more closely tied to risk sentiment than to safe-haven dynamics, giving it a degree of procyclicality that it shares with many EM currencies. The practical implication is that a EUR-based investor holding EM local currency debt experiences meaningfully lower cross-currency volatility than a USD-based peer investor. When EM currencies weaken, the euro tends to weaken too, partially cushioning the FX impact. Figure 11 shows that the EUR's absence of safe-haven status becomes a structural advantage when accessing EM local debt: The investor's base currency aligns more naturally with the asset class, reducing FX volatility and drawdowns that make the same trade more costly for USD-based investors.

Figure 11: GBI-EM drawdown from peak measure in EUR vs. USD (%)



Notes: Drawdown measured as percentage decline from prior peak on a monthly total return basis. EUR unhedged reflects local currency returns converted to EUR without currency hedge. USD unhedged reflects the same index from a USD investor perspective.

Sources: JP Morgan Markets, Allianz Research

The strong progress in EM monetary policy credibility increases the diversification benefits of investing into EM local currency debt for DM investors. EM central banks have moved decisively away from the exchange rate stabilization bias that historically characterized their policy frameworks, adding on average 780bps to policy rates during the post-pandemic tightening cycle compared to just 400bps for advanced economies (IMF, 2024). Crucially, this tightening was front-loaded and aggressive even at the cost of short-term economic pain, signaling a genuine commitment to domestic inflation targeting over growth stabilization. For a globally diversified, DM-based fixed-income investor, a decent EM local currency allocation provided significant diversification benefit during the painful global rates repricing following the Covid-19 and Russia-Ukraine shocks: A sharp EM sell-off driven by rates and FX has been followed by a much faster recovery compared to home currency fixed-income investments.

These assessments are, as always, subject to the disclaimer provided below.

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(v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the EUR/USD exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures,
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