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CIO Viewpoints

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#Investment #CIO Insights #Bond Markets #Emerging Markets Bonds

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Why Emerging Market Bonds Outperform Developed Markets?

Emerging market (EM) bonds have significantly outperformed developed market (DM) bonds this year. So far in 2026, the bond market has shown a “counterintuitive” but defensible outcome: DM bonds are down ~1% YTD, while EM has delivered stronger returns across both hard-currency (USD) sovereign debt and local-currency government bonds. This outperformance reflects both structural and cyclical tailwinds rather than a single catalyst.

Carry is the first driver. EM offers meaningfully higher carry, supported by wider spreads and higher real yields. For example, EM local government benchmarks still show yield-to-worst around ~6.5%, above the five-year average and well ahead of DM yields. More importantly, 1-year EM government yields are ~3pp above expected 2026 inflation, implying positive real returns. In contrast, real rates across parts of the US/Europe are near zero. Meanwhile, With US yields still exposed to inflation risk, EM USD sovereign indices have generated ~3% coupon return in the first half of the year, making it an effective hedge against USD duration risk.

Monetary policy divergence favours EM. Several EM central banks have room to ease as inflation moderates (e.g., Mexico, Brazil), supporting local bond prices. In Indonesia, foreign inflows into local currency bonds have risen to a 13-month high, as investors view that the hiking cycle is nearing an end and that regional yield differentials remain attractive. Meanwhile, the Fed and ECB remain relatively hawkish, keeping pressure on long-end DM yields.

Improving fundamentals and scope for spread tightening. Rating agencies continued to record net EM sovereign upgrades from late 2025 into 2026, reflecting improving fiscal and external balances in parts of EM. As risk sentiment improves, EM credit spreads can tighten further. Meanwhile, several EM currencies, including the RMB, have strengthened this year, supporting carry trades across Asia. If the USD remains range-bound, a key barrier to EM debt allocation reduces and encourage global inflows into the EM fixed income.

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