

# Emerging Market Macro Insights

## Monthly report

**Invesco Fixed Income**

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### Overview

- We expect EM local debt to perform well this year, helped by narrower EM growth differentials versus the developed world, a weakening US dollar and a cheap starting point, in our view, for EM local debt valuations.
- We expect the trade war to settle over the summer, leaving tariffs at manageable levels and allowing the Fed to cut rates. Potentially falling US Treasury yields could support positive returns for EM external debt.

## Panel Q&A with Invesco EM Debt Team

### Market outlook

Policy uncertainty and slowing US economic growth have challenged the narrative of US exceptionalism, and the US dollar has started to weaken. Ongoing trade and geopolitical uncertainties have also prompted countries outside the US to adopt more pro-growth agendas, such as domestic reforms and increased local spending, driving growth outside the US. Narrowing growth differentials, a weakening US dollar, and a cheap starting point for valuations, in our view, make the emerging market (EM) asset class a potential destination for investors looking to reallocate capital outside the US. In this issue, we speak with the Invesco EM Debt Team to gain insight into the US economy and the EM debt asset class.

### Outlook on the US economy with Turgut Kisinbay

#### How would you describe the current state of the US economy, and what is your outlook for the remainder of 2025?

**Turgut:** We expect the US economy to slow in the coming months, driven by several headwinds. Most notably, trade policy is exerting upward pressure on prices, reducing household incomes, increasing input prices for production, and in some cases risking access to production inputs. Elevated uncertainty around trade and fiscal policies—such as canceled government contracts and grants—adds to the drag, alongside tighter financial conditions stemming from a weaker stock market and higher interest rates.

That said, the depth of a potential slowdown remains uncertain. The US economy has shown remarkable resilience post-pandemic, and some policies may still be postponed or reversed. It is also possible that the policy mix will shift toward more market-friendly measures, such as tax cuts and deregulation. Our baseline outlook suggests a 55% probability of a soft landing, but still-elevated 45% chance of recession.

#### What impact do you expect US tariffs to have on US inflation and growth?

**Turgut:** We view the current trade policy as a negative supply shock, which is likely to bring some combination of slower growth and higher prices. At this point, it is unclear which effect will dominate. We expect Core Personal Consumption Expenditures (PCE) inflation to remain elevated in the 3.5% to 4% range, and growth to fall below potential.

In our orderly slowdown scenario, we project Q4-over-Q4 2025 growth of 0.8%. In a recession scenario, growth could be marginally negative over the same period.

#### When will we likely see the implementation of growth-friendly policies such as deregulation and tax reform? What impact might they have?

**Turgut:** The timeline for growth-oriented policies remains uncertain. The Trump administration has focused heavily on trade policy, while measures like an extension of the Tax Cuts and Jobs Act (TCJA) are still being debated in Congress and unlikely to pass before summer. As

such, any meaningful economic impact from tax reform will likely be a 2026 story.

Similarly, deregulation has not been a front-loaded policy priority. If pursued, its impact would also likely materialize closer to 2026.

**How do you see the US dollar performing over the coming months, and what implications might that have for trade and capital flows?**

**Turgut:** We expect the US dollar to weaken due to a US-driven slowdown that reduces the country's relative growth advantage. Our earlier expectations of continued US outperformance have faded, narrowing the growth gap with other economies.

This shift, along with a reversal of the "American exceptionalism" narrative and the high share of US assets in global portfolios, could prompt a rebalancing of capital away from the US. Concerns over Federal Reserve (Fed) independence and persistent large fiscal deficits may further dampen investor appetite for US assets, reinforcing the case for US dollar weakness and global portfolio rebalancing. Finally, standard valuation models suggest that the US dollar is expensive in real terms, which could eventually lead to a dollar weakness cycle, and we may be at the beginning of such a cycle.

**Do you anticipate the Fed to cut rates this year? If so, when and by how much?**

**Turgut:** Rate cuts will likely depend on which growth scenario materializes. In an orderly slowdown, we would expect the Fed to begin cutting rates gradually, starting in September, with three 25 basis point cuts by the end of the year. In the event of a recession, the Fed would likely cut more aggressively—by at least 200 basis points—potentially on a more accelerated timeline.

Rate cuts will likely help ease financial conditions and cushion a slowdown, though they are unlikely to fully offset the headwinds, in our view, especially in a hard-landing scenario.

**Outlook on EM local debt with Wim Vandenhoeck**

**What is your outlook for EM debt performance for the remainder of 2025? How do you currently see fundamentals, valuations, and market technicals?**

**Wim:** EM assets have been largely ignored over the last decade, as US equities and the US dollar have outperformed, leading to cheap EM valuations. As US exceptionalism peaks, global investors are gradually redirecting their allocations to other opportunities. External and local EM debt have now become attractive alternatives, in our view, that investors have under-allocated to over the last decade, as US tech and US dollar performance have taken all the glory. A significant shift in US trade policy may be causing an adverse economic impact on the US and it remains uncertain what the medium-term impacts may be. This is leading to an environment in which US growth will likely slow, inflation may not fall as much as expected, and the uncertainty created may lead to a prolonged period of lower potential US growth.

One of the consequences of this new trade policy, and the transactional approach taken, is the creation of incentives for regions with the fiscal room to stimulate their economies. Their own pro-growth policies could help them absorb trade shocks or redirect their own economies for the longer term to become less dependent on the US. Typically, a US slowdown would be paired with a stronger US dollar. However, these new policies have created a shock and are leading to an environment in which slower growth and stable to higher inflation are weakening the US dollar and in turn, strengthening other currencies. This could allow other central banks to lower interest rates without the usual fear of creating pass-through inflation on the back of a weakening currency.

In summary, narrowing growth differentials, a weakening US dollar, and what we view as a cheap starting point for valuations make the EM asset class a potential beneficiary of flows that may be diverted away from US equities. Against this backdrop, we believe EM local debt could yield strong returns this year, but they may depend on how aggressively the Fed moves and the severity of the economic slowdown.

**Given the current level of global uncertainty, how do you expect EM central banks to navigate monetary policy for the remainder of the year?**

**Wim:** We believe the majority of EM central banks still have space to continue their rate cutting cycles. With inflation pressures subsiding and potential pass-through inflation not a factor, we expect some central banks to cut rates by more than what is currently priced in, as they address various growth challenges. However, others may adopt a more gradual approach, considering the domestic challenges they may face.

With Brazil approaching the middle of its hiking cycle, we see room across Latin America for lower rates by the end of the year. In Central and Eastern Europe, there is likely less room for unexpected moves, however, sharply declining inflation makes exposure attractive, in our view. Idiosyncratic stories like Egypt and Turkey present their own opportunities, while South Africa will likely deliver the rate cuts that are currently priced in. The latter, however, may also benefit from ongoing structural reforms. Most central bank actions in the last few months have come out of Asia, which we expect to continue. Many of the low-yielding countries face growth pressures due to new trade policies and have not faced the inflation issues seen in other EMs. Consequently, they may have the greatest room to cut.

**What is the role of the US dollar in your outlook and how do you see the US dollar playing out this year?**

**Wim:** US asset returns will likely remain under pressure for the foreseeable future, which will likely continue to pressure the US dollar. However, even after the recent correction, the US dollar's valuation still appears elevated, in our view. Although we expect some short-term reversal driven by headlines, we believe the overall trend is firmly in place. These headlines will likely center around the ultimate terminal tariff rates, broader trade restrictions, the drag on corporate profits and real household incomes, the independence of US institutions, fiscal policies and how the rest of the world responds. For this year, we continue to expect a gradually weaker dollar against developed market currencies and a wider range of outcomes versus EM currencies, where we could see some larger corrections.

**Is there a particular region or regions where opportunities stand out this year?**

**Wim:** EM performance is likely to be more driven by idiosyncratic stories than regional ones. Factors such as initial rates and currency valuations, US trade policies, the scope of fiscal policies, and ongoing election cycles will likely determine the performance winners over the next 12 months. While we expect solid beta performance for the remainder of the year, the market environment is ripe for significant alpha as well, in our view. Given the challenges to global growth (as indicated by International Monetary Fund (IMF) revisions), small open EM economies like the Czech Republic, Chile, and possibly Mexico may face greater obstacles, while more closed economies such as Brazil and Indonesia, along with oil importing nations like India and Turkey, may derive benefits from the new trade order.

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**Outlook on EM credit with Jason Trujillo and Daniel Phillips**

**What is your outlook for EM credit performance for the remainder of 2025? How do you currently see fundamentals, valuations, and market technicals?**

**Jason:** As a US dollar-denominated asset class that trades with a spread to US Treasuries, EM external credit depends more on how things play out in the US than EM local markets do; however, we think the balance of risks are to the upside. Spreads on US dollar-denominated EM credit will likely widen if there is a US recession, leading to potentially negative returns (versus a 2.84% return YTD for EM hard currency sovereigns).<sup>1</sup> However, we believe the trade war will settle over the course of the summer, and tariffs will end up at manageable levels, significantly reducing overall uncertainty. This would leave the Fed in a better position to cut rates, potentially driving positive returns for EM external debt, due to potentially falling US Treasury yields and modest spread contraction.

While EM hard currency's full 2025 performance will likely depend heavily on what happens in the US, some ebbing of US exceptionalism is likely, in our view. In the IMF's admittedly speculative World Economic Outlook, published in the midst of the trade war in April, it slashed developed market growth rates more deeply than it cut EM growth rates, increasing the delta between the

two from 2.3x to 2.6x. Even if the trade war ends tomorrow, lingering policy uncertainty will likely have a growth cost for the US. Well-run investment grade sovereign credits with low external debt will likely look more attractive than developed markets, and stronger high-yield stories, such as post-COVID crisis reform stories, countries with IMF programs and those with significant political transitions, will likely boost overall index returns.

**What are the current macro drivers shaping EM credit? Has the fluctuation in the US dollar impacted EM credit spreads and flows?**

**Daniel:** Nobody knows where global tariffs and trade relations will actually end up or when they will be settled. This widening difference in policy certainty between developed markets – largely the US – and EM is currently driving EM returns and flows. The impact can be seen in two interrelated ways – relatively stable EM spreads and a weakening US dollar. Given the implications of the tariffs announced on “Liberation Day”, it would make sense for hard currency EM spreads to be much wider, and yet they are relatively flat.<sup>1</sup> There are still worries of a US recession, which has historically been associated with a large move wider in EM spreads and outflows from the asset class. We have seen large net negative hard currency outflows since the beginning of April, but they have not yet had a meaningful negative impact on spreads. We believe this is partly because policymaking in many EMs seems sounder than in the US, i.e., no attacks on central bank independence, more certainty over trade policy, and low debt.

We believe US dollar weakening is a function of global rebalancing away from US assets, such as equities, because of policy uncertainty created by Trump administration policies. This could be reversed in a true risk-off event, but for now, it reflects the unwinding of a long-running surge of global money into the US. Spreads are holding in relatively well for EM and the US dollar is weak because EM’s political leadership and macro framework are collectively seen as more predictable than the US administration’s.

**Where are most EMs in their respective credit cycles?**

**Jason:** Following policy-induced slowdowns and a number of recessions across EM through mid-2024, domestic growth cycles have been slow to pick up across EM. This is illustrated by a limited rebound in private sector credit growth, despite broad policy easing across EMs. On average, year-over-year credit growth has been in the single digits since mid-2024 and GDP growth data mirror this trend. Where the domestic economy is recovering faster, private consumption supported by real wage growth has driven growth, rather than credit expansion and investment recovery.

**Is there a particular region or sector where opportunities stand out this year?**

**Daniel:** In external credit, we believe idiosyncratic high yield names offer the most attractive opportunities. We expect elevated US Treasury yields, elevated spreads in the high yield segment, and some strong qualitative stories, such as reforms and positive political developments, to drive positive returns, similar to the post-crisis period of 2009 and 2010, with recoveries likely faster and sharper than for US high yield and distressed names. In investment grade EM sovereign debt, there is little room for additional spread compression, in our view, which potentially leaves only a rally in US Treasuries to drive returns this year. However, high yield EM remains relatively cheap to its historical levels in spread terms, in our view, and we believe certain names have the opportunity for gains, such as Argentina, Ecuador, Senegal, Ghana, Zambia, and Pakistan.

1. Source: Invesco. JPM EMBI Global Diversified Index. Data as of May 19, 2025.

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Non-investment grade bonds, also called high yield bonds or junk bonds, pay higher yields but also carry more risk and a lower credit rating than an investment grade bond.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

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All data as of May 22, 2025, unless otherwise stated. All data is USD, unless otherwise stated.

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