

POTENTIAL REASONS FOR OPTIMISM ON EMERGING MARKET LOCAL CURRENCY DEBT

INVESTMENT VIEWS
FROM THE BNY INVESTMENT INSTITUTE

Asset Class View

KEY TAKEAWAYS

- 1** Emerging market local currency (EMLC) debt may be growing more attractive given the weakening U.S. dollar (USD) and a more supportive global market.
- 2** Emerging markets (EM) central banks appear to be more accommodative, providing duration gains.
- 3** EM governments are showing more signs of stability with stronger debt management activity.
- 4** Emerging markets may be an option or investors seeking diversification from domestic allocations.

The case for emerging market local currency debt

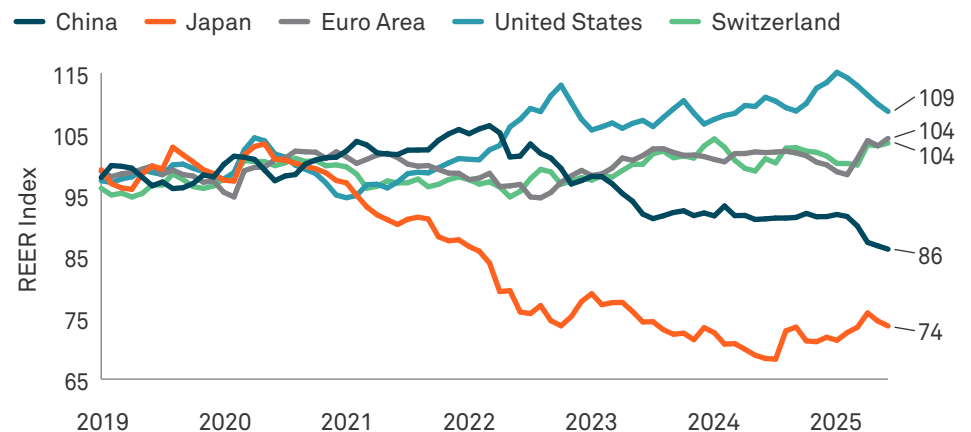
Following a prolonged period of mediocre performance, we think Emerging Market Local Currency (EMLC) debt looks attractive and forecast a total return in the year ahead of 10.0%. We expect returns to exceed other credit asset classes, as the global backdrop shifts favorably for emerging markets.

A combination of factors is converging to build a notable investment case. Structurally, a weaker U.S. dollar bolsters local currency returns, which along with cooling inflation, creates more room for EM central banks to maneuver rates. When combined with relatively strong fiscal positions and attractive values, we think EMLC provides an interesting potential diversification opportunity for investors.

A weaker dollar historically bodes well for EMLC debt.

Following a period of strong performance, the U.S. dollar has declined notably in 2025, and our probability-weighted forecast sees further weakening in the year ahead

CHART 1 — The USD may have been overvalued by as much as 15% in recent years.



Data as of July 30, 2025. Sources: BNY Investment Institute, BIS, Macrobond. Charts are provided for illustrative purposes and are not indicative of the past or future performance of any BNY Mellon product.

The U.S. dollar weakness trend reflects a recent increase in foreign exchange (FX) hedging by asset owners with significant dollar-based claims seeking to protect against currency fluctuations. These asset owners are typically based in countries with current account surpluses. Looking forward, we expect more diversification across global capital flows as U.S. growth and interest rate differentials relative to other developed economies narrow through 2026.

A weaker dollar historically bodes well for EMLC debt by directly increasing the value of emerging market (EM) currencies.

What's more, a weakening dollar also tends to generate greater "policy space" for EM central banks to cut rates. In turn, EM rate cuts are likely to provide gains on duration with bond price increases (given that when yields fall, bond prices rise).

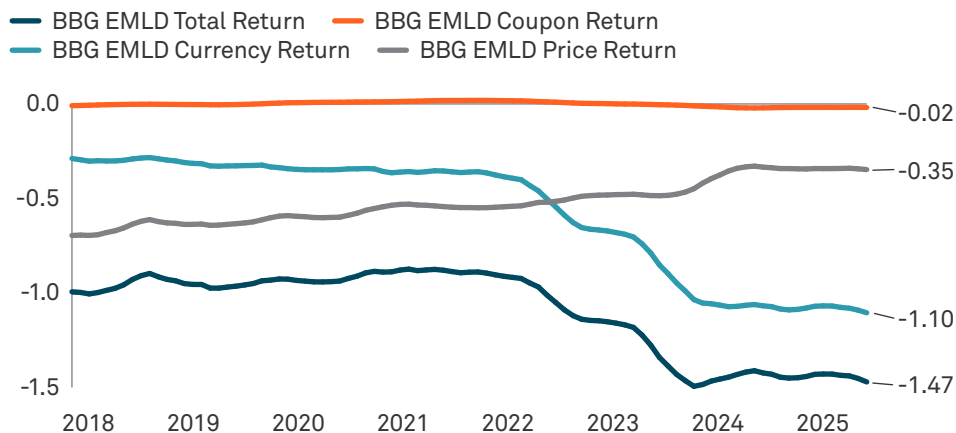
Cooling inflation in emerging markets

Amid the ongoing rise in trade frictions, easing global growth, contained oil prices, and a glut of Chinese manufacturing exports, inflation in emerging markets is likely to fall.

Inflation in Asia is already within target and poised to moderate further. Latin America and Eastern Europe are encountering inflation slightly above target, but the trend is downward. Meanwhile, U.S. inflation is expected to rise again or remain stubbornly above target due to tariffs, which may make EM bonds look more attractive by comparison.

With these notable tailwinds, we believe the backdrop turns favorable for EMLC with falling inflation, potential rate cuts, and rising bond values.

CHART 2 — EM index component betas (or sensitivities) to the USD show price and currency returns tend to rise (fall) meaningfully for a given depreciation (appreciation) of the USD.



Data as of August 4, 2025. Sources: BNY Investment Institute, Bloomberg, Macrobond.

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Note: Regression slope coefficients, monthly data (100 obs).

EM governments appear to be managing their finances better

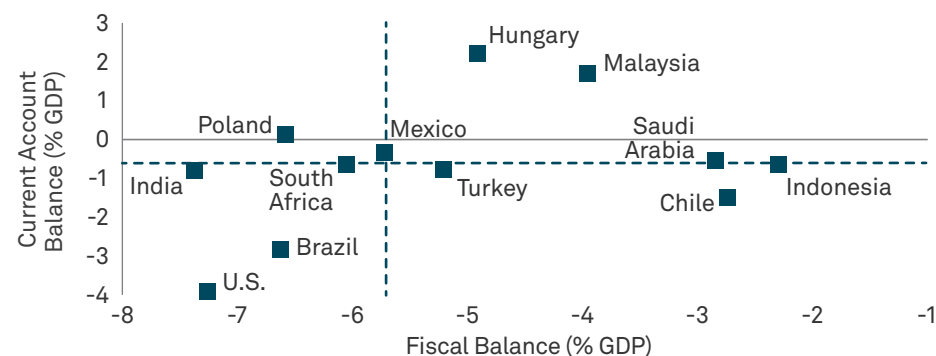
Historically, a common concern for EM investors is the stability of the governments and their finances (i.e., debt trajectories). However, the data today paints a different picture.

Data from the International Monetary Fund (IMF) shows, compared to G7 counterparts and China, many EMs

have relatively low government debt and manageable deficits. The average government debt in major EMs is around 65% of GDP, below the 122% average in G7 countries and China.

Additionally, emerging market governments' "twin deficits" (fiscal and current account deficits) are better positioned than the U.S. We think these fundamentals will better insulate EM economies from abrupt turns in global capital flows and potentially act like a cushion against unforeseen shocks.

CHART 3 — EM twin deficits appear to be better positioned than the U.S.



Data as of July 30, 2025. Sources: BNY Investment Institute, IMF, Macrobond.

Note: Twin deficit = government fiscal and current account balance (% GDP), as of 2024.

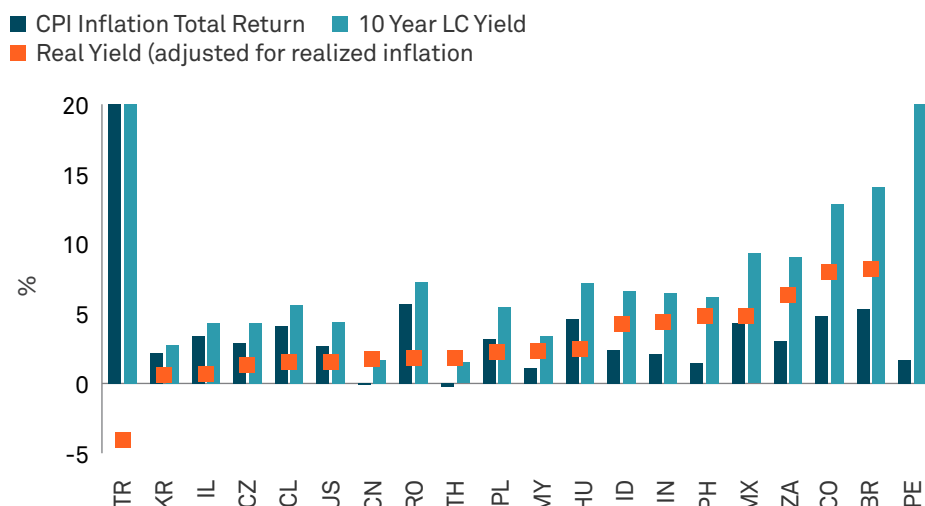
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Attractive valuations

Finally, from a valuation standpoint, EM currencies — adjusted for inflation — are generally cheap relative to history, providing a potentially attractive entry point for investors seeking exposure.

Additionally, real yields — also adjusted by inflation — are wide. Notably, the real yield on many long-dated EM government bonds is currently higher than the underlying inflation rate itself, highlighting significant inflation compensation.

CHART 4 — Real yields across select EMs are attractive — in several instances the real bond yield exceeds the current rate of inflation.



Data as of July 30, 2025. Sources: BNY Investment Institute, Macrobond.

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What We are Watching

As with any investment case, there are several considerations to our outlook. An abrupt end to the trade war in a way that quickly revives American “exceptionalism” would strengthen the dollar and fuel expectations of a Federal Reserve (Fed) hiking cycle – a macro scenario to which we currently assign the lowest probability.

Acute political instability in major emerging markets could have contagion effects across the asset class. However, we’ve already seen a slew of EM elections in 2023 and 2024, which should contain (but, admittedly, not eliminate) the risk of widespread instability.

Unexpected twists in global (non-U.S.) trade patterns and supply chain shifts could introduce additional volatility.

With these considerations in mind, we nevertheless believe that there is a strong case for EMLC, supported by trends in currencies, inflation, valuations and policies. Additionally, given a potential slowdown in U.S. growth and uncertain trade and macroeconomic backdrops, an allocation to EMLC may serve as a valuable diversification tool, along with helping investors unlock more sources of returns.

About the BNY Investment Institute

Drawing upon the breadth and expertise of BNY Investments, the Investment Institute generates thoughtful insights on macroeconomic trends, investable markets and portfolio construction.

Glossary and index definitions

Asset allocation and diversification cannot ensure a profit or protect against a loss.

BBG EMLC Index: The Bloomberg EM Local Currency Government 10% Country Capped Index is a country-constrained version of the flagship Emerging Markets Local Currency Government Index, which is designed to provide a broad measure of the performance of local currency Emerging Markets (EM) debt.

Real yield: Difference between nominal yield minus inflation.

CPI inflation: Represents changes in prices of all goods and services purchased for consumption by urban households.

Investors cannot invest directly into any index.

Risks

No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

Equities are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees. Investing in **foreign denominated and/or domiciled securities** involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries. **Currencies** can decline in value relative to a local currency, or, in the case of hedged positions, the local currency will decline relative to the currency being hedged. These risks may increase volatility. **Bonds** are subject to interest rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines.

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