



RAOUL LUTTIK

Lead Portfolio Manager
Emerging Markets Debt Local Currency Strategies

LEONARDO BERNARDINI, CFA

Client Portfolio Manager
Emerging Markets Debt

EM Local Currency Debt: A Revitalised Opportunity for European Investors

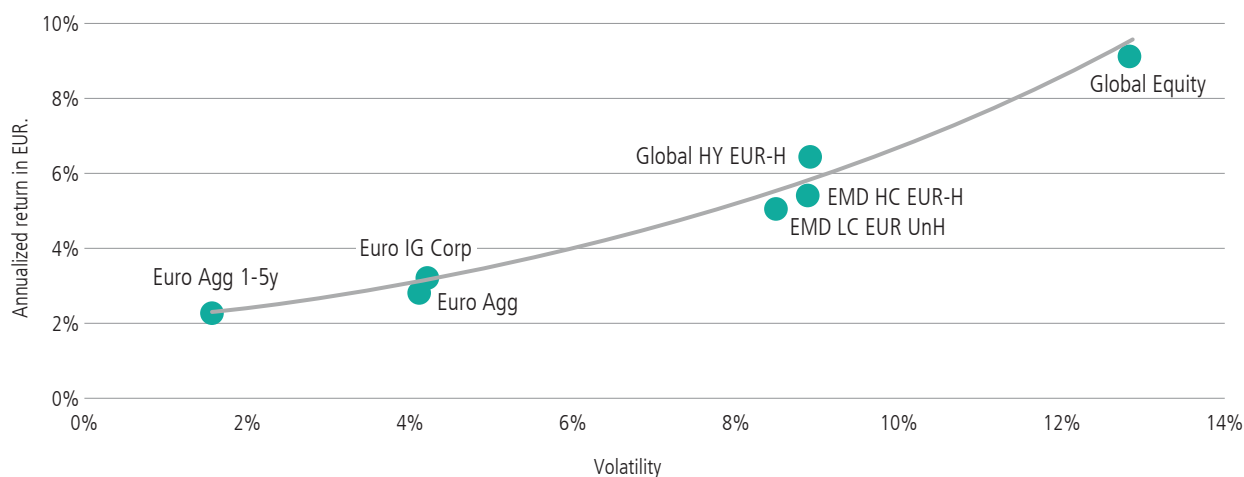
Emerging markets local currency debt offers some of the most compelling income and diversification characteristics in global fixed income. Improving fundamentals, high real yields and a more benign local currency backdrop in recent years point to a potentially attractive entry point—for both new allocations and long-term holders reassessing their exposure. This paper assesses the opportunity through the lens of a European investor, given the distinct risk/return dynamics of investing in this asset class in euros.

For many European institutional investors, emerging markets local currency (EMD LC) debt still sits firmly in the “high-risk bucket,” associated with volatile currencies, fragile macroeconomics and unpredictable politics. The renewed turbulence emanating from the Middle East—with its attendant oil price pressures, risk-off capital flows and currency volatility—will do little to dispel that perception in the near term; yet it is precisely in moments like these that the structural transformation quietly reshaping the asset class deserves the closest attention.

From a euro base-currency perspective—as well as others including sterling and Nordic currencies—EMD LC has historically delivered a risk-return profile in between core euro fixed income and global equities. Long-term euro-based returns (2003 – 2025) have been around 5% per year (see figure 1) with significantly lower volatility than global equities and slightly lower volatility than a typical euro hedged-EM hard currency index and global high yield bonds.

Importantly, correlations with other major asset classes such as euro aggregate bonds, euro investment-grade credit, EM hard currency, global high yield and global equities have been only moderate (see figure 2). For a European portfolio, EMD LC is not just “more EM risk,” but a distinct building block combining local rates, inflation and FX dynamics. It can help bridge the gap between low-yielding euro bonds and higher-risk growth assets.

FIGURE 1: HISTORICAL RISK/RETURN IN EUR – SINCE 2003



Source: JPMorgan, Bloomberg. Period: 31 December 2002 – 31 January 2026. Indices used: Bloomberg Euro Agg 1-5y Index; Bloomberg Euro Aggregate Index; Bloomberg Euro Agg Corporate Index; JPM EMBIGD Eur-hedged Index; JPM GBI-EM GD Unhedged in EUR Index (EMD LC EUR UnH), Bloomberg Global High Yield Corporates Index Eur-hedged.

FIGURE 2: CORRELATION WITH EMD LC

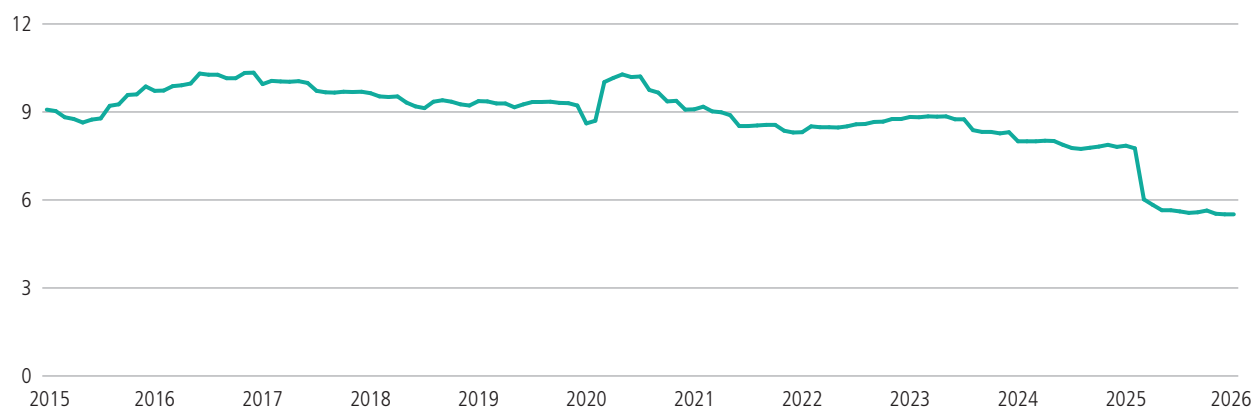
Euro Agg	0.37
Euro IG Corp	0.49
EMD HC EUR-H	0.57
EM Equity	0.64
Global HY EUR-H	0.46

Source: JPMorgan, Bloomberg. Period: 31 December 2002 – 31 January 2026. Indices used: Bloomberg Euro Agg 1-5y Index; Bloomberg Euro Aggregate Index; Bloomberg Euro Agg Corporate Index; JPM EMBIGD Eur-hedged Index; JPM GBI-EM GD Unhedged in EUR Index (EMD LC EUR UnH), Bloomberg Global High Yield Corporates Index Eur-hedged.

Over this long timeframe (2003 – 2025) the asset class has grown significantly, with local government bond markets expanding to \$21 trillion at the end of 2024.¹ More than 90% of EM debt issuance is in local currencies today, making them less dependent on external financing or vulnerable to currency mismatches. While China is a dominant driver of recent asset class growth and total debt stock, local currency government bonds from other EM countries still represent over \$10 trillion, matching the size of the entire US corporate debt market.

As the asset class has been maturing over time, its volatility level has exhibited a declining trend; the figure below illustrates how on a rolling five-year basis, volatility has declined over the past 10 years from around 10% to just under 6% (see figure 3), including a notable decrease in recent years as the period of Covid market stress rolled off. Geopolitical shocks—such as the current conflict in the Middle East—can temporarily punctuate that trend, but the structural forces underpinning the decline remain intact.

FIGURE 3: 5Y ROLLING VOLATILITY GBI-EM GD IN EUR



Source: JPMorgan.

EMD LC: Turning a Corner

While EMD LC has delivered solid returns over the long term, there’s no escaping the asset class has experienced notable headwinds since 2013, which have dragged the performance below the long-term average. In the main, this was due to events like the so-called “taper tantrum” in 2013, which exposed sizable current account deficits across a number of major EM countries, driving strong currency adjustments. Pandemic related disruptions to growth and fiscal balances, and aggressive tightening of global and EM interest rates, have also been significant headwinds.

For some allocators, this has reinforced caution. Yet these same developments have, in our view, reset the opportunity. External imbalances have corrected significantly, with average current accounts deficits across the EM local universe nearing zero today. EM central banks moved early and forcefully against post COVID inflation, lifting policy rates to restrictive levels. Local curves now embed high nominal yields and attractive real yields.

Fundamentals: EM on Stronger Footing

Given this backdrop, today’s case for EMD LC also rests on a meaningful improvement in underlying fundamentals, which, after years of outflows, has helped drive increasing inflows into the asset class (creating a technical tailwind) particularly since April last year. In our view, there are three key areas of improvement.

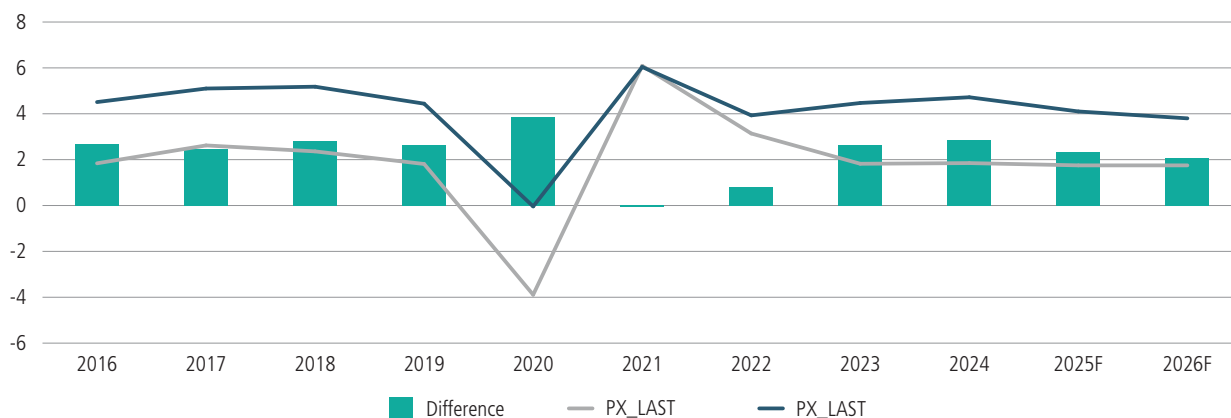
¹ Source: Bank of America.

First, emerging economies are expected to grow around 4% in 2026, roughly two percentage points faster than developed markets (see figure 4). This premium is supported by resilient exports, particularly from manufacturing-led economies; AI-related capital expenditure in Asia, reinforcing investment along technology supply chains; and favourable terms of trade and currencies for metals exporters in EMEA and Latin America. Indeed, booming precious metals and copper prices, driven by rising structural demand tied to data center buildouts and electric vehicle manufacturing, alongside constrained supply, have benefited key commodity exporters such as Chile, Peru, South Africa and Zambia. However, it is worth noting that where those economies carry meaningful energy import exposure, rising oil prices driven by Middle East instability can partially offset terms-of-trade gains, making country-level energy dependency an increasingly important differentiator. What's more, despite the tariff turmoil in the past year, EM export volumes have been on a strong trend going into 2026 (see figure 5), even if near-term disruption to Gulf energy supply chains introduces some uncertainty into the regional export data outlook. Stronger export revenues are supporting current accounts and EM currency performance, with energy and metals exporters among the clearer near-term beneficiaries of the current commodity price environment.

Second, a notable structural change has seen EM inflation converging toward developed-market levels. Many EM central banks now operate credible inflation-targeting regimes and responded to the post-pandemic inflation shock earlier than the U.S. Federal Reserve or European Central Bank. The result has been anchored expectations, less risk of entrenched high inflation and clearly positive real policy rates. For bond investors, that translates into more reliable real income rather than simply compensation for inflation risk.

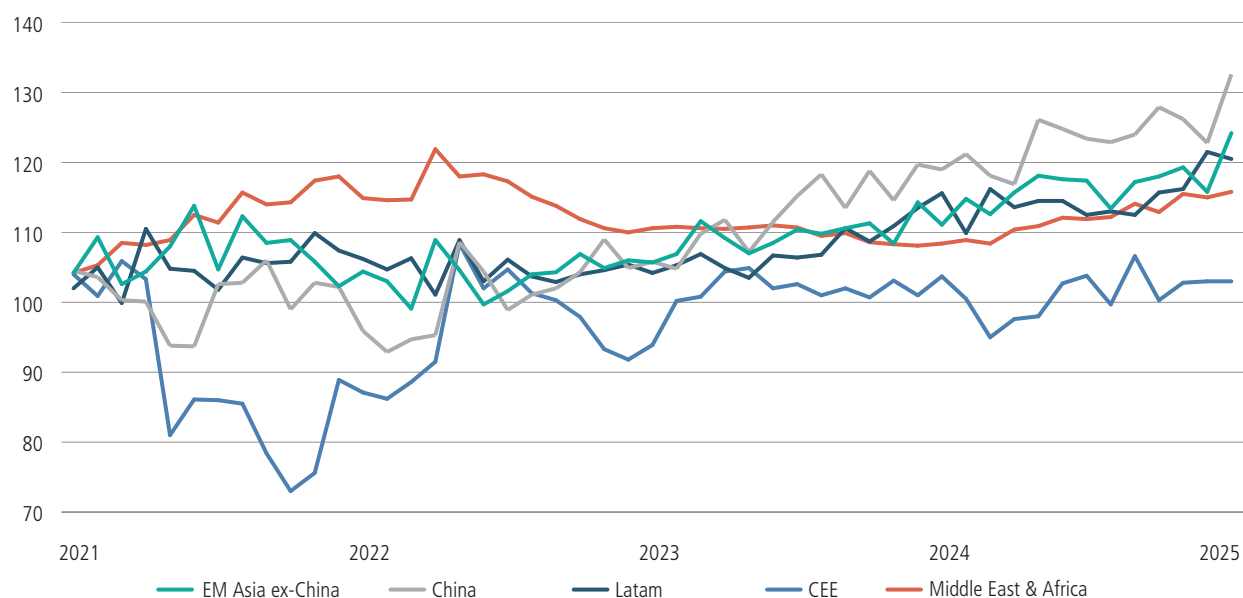
Third, credit trends have also been supportive. Improving fiscal trends following the pandemic shock and declining balance of payments risks are being followed by a trend of rating upgrades outpacing downgrades. Average public debt/GDP ratios for the local currency universe stand at 61%, and well below the 110% average reported by the International Monetary Fund for developed economies in 2025. In addition, 80% of the asset class is currently investment grade, based on the JPM GBI-EM GD index, and different non-investment grade countries have been seeing upgrades lately such as South Africa. An even stronger upgrade trend has been visible across frontier local markets outside of the mainstream benchmarks, such as Nigeria, Egypt and with potential future investment grade status for markets like Costa Rica and Morocco. This shift strengthens the argument that EMD LC can serve as a long-term, quality-anchored allocation, not just a tactical trade.

FIGURE 4: REAL GDP GROWTH (%) EMERGING MARKETS VS. DEVELOPED MARKETS



Source: Based on NB EMD Team forecasts for 2025/2026 EM growth, Bloomberg consensus forecasts for 2025/2026 DM growth, Bloomberg data for historical 2016-2024 EM and DM growth data, as at January 20, 2026.

FIGURE 5: EM EXPORTS VOLUME INDICES



Source: CPB Export Volume Indices. Data as at 30 November 2025. For illustrative and discussion purposes only. Nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. This material is not intended as a formal research report and should not be relied upon as a basis for making an investment decision. Investing entails risks, including possible loss of principal. Historical trends do not imply, forecast or guarantee future results. Nothing herein constitutes a prediction or projection of future events or future market behaviour. Due to a variety of factors, actual events or market behaviour may differ significantly from any views expressed.

Valuations: High Real Yields and Rich Dispersion

If fundamentals explain the strategic case, valuations support the timing.

At index level, EMD LC yields are close to 6% in nominal terms (see figure 6), offering roughly a 3% pickup versus a euro aggregate bond index, while the average credit rating remains investment grade.

Real yields—nominal yields minus inflation—are around 3.5% (see figure 7), toward the top of their historical range. In a world where most euro-denominated bonds offer relatively slim real yields, this is a scarce source of robust, inflation-adjusted income.

Dispersion also runs strongly by region: Latin America generally offers the highest nominal and real yields with average nominal bond yields currently over 9%; Asia tends to provide lower yields but stronger balance sheets; and EMEA includes amongst others a mix of CEE countries with high correlation to the Euro, and African commodity exporters benefiting from improved metals-related terms of trade.

This dispersion is precisely what makes EMD LC a rich hunting ground for expert active managers.

FIGURE 6: YTW – EMD LC VS. MAJOR EURO(-HEDGED) FIXED INCOME INDICES

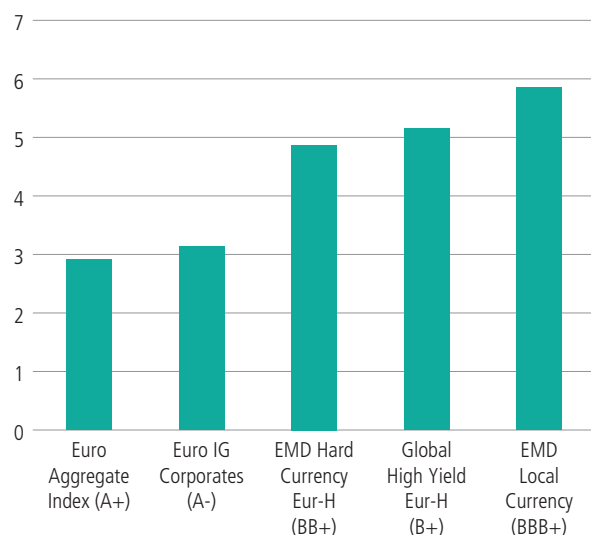
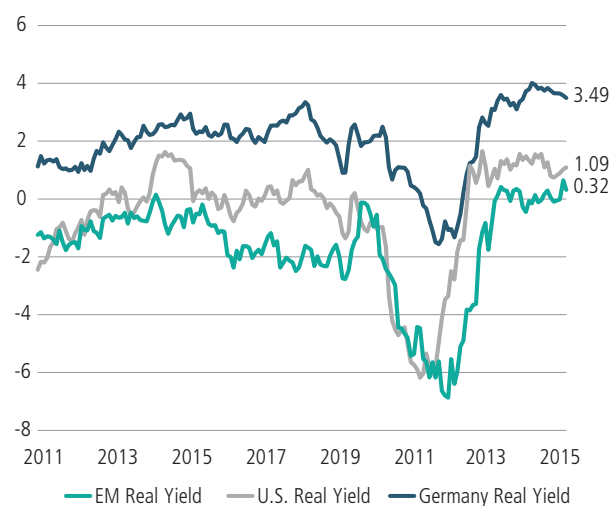


FIGURE 7: EM REAL YIELD VS. US AND EUROPE



Past performance is not necessarily indicative of future results.

LHS Source: Bloomberg, JPMorgan, BlackRock Aladdin. Indices used: Bloomberg Euro Aggregate Index; Bloomberg Euro Agg Corporate Index; JPM EMBIGD Eur-hedged Index; JPM GBI-EM GD Unhedged in EUR Index (EMD LC EUR UnH), Bloomberg Global High Yield Corporates Index Eur-hedged. For Euro-hedged indices, implied hedging costs are incorporated in the YTW data. Data as at 31 January 2026.

RHS Source: Bloomberg, JPMorgan, as at 4 February 2025. EM Real Yields based on the current GBI-EM Global country universe, excluding Dominican republic, Serbia, Turkey and Uruguay; based on GBI-EM Yields minus historical CPI for each country, and their current normalized GBI-EM GD Index weight fixed through time. US Real Yield based on 5-year US Treasury yield minus US CPI. Germany Real Yield based on 5-year Bund yield minus Germany CPI. Data as at 31 January 2026.

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The Currency Dimension: From Headwind to Potential Tailwind

Currency risk is the defining and most visible risk for investors in EMD LC. In recent years—especially during the euro’s 2025 rally—it has also been a significant performance headwind for euro-based investors.

Looking ahead, the FX picture appears more balanced, though the path is unlikely to be linear. The euro has already repriced much of its relative strength, limiting further upside on fundamentals alone. Many EM currencies still look inexpensive on REER measures versus the euro (see figure 8). And a softer US dollar and easier global financial conditions have historically coincided with stronger EM FX, especially for high carry currencies. The principal near-term risk to this constructive view is an energy-driven reassertion of dollar strength: sustained oil price pressure, of the kind that prolonged Middle East conflict can generate, has historically tightened global financial conditions and prompted risk-off flows that weigh disproportionately on carry-sensitive EM currencies. Importantly, the impact is not uniform—energy-exporting EM economies tend to see currency support in such environments, while energy importers face greater headwinds, making country-level differentiation more consequential than usual.

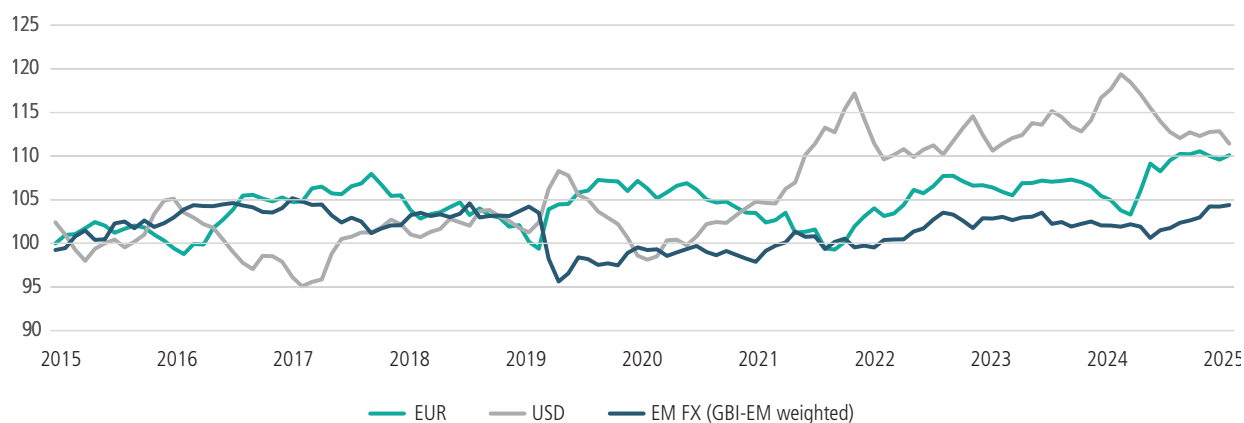
While currency volatility will remain, the combination of cheaper relative valuations, high carry and broadly improved EM fundamentals meaningfully improves the risk-reward profile for euro-based investors—even when short-term geopolitical pressures cloud the near-term FX outlook.

Even with this case, however, the opportunity in EMD LC does not negate the need for careful risk management. Core risks include:

- **Geopolitical and US policy risks:** In the near term, investors face the risk that the Iran conflict in the Middle East lifts oil prices further and rekindles inflation, while US trade policy uncertainty and an uncertain Fed rate path may tighten global financial conditions.
- **FX volatility:** The main source of short-term return swings, driven by shifts in risk sentiment, rate expectations and country-specific events.
- **Interest rate risk:** Local yield curves can be volatile where inflation or policy credibility come into question, making duration management vital.
- **Credit and political risk:** Fiscal fragility, reform fatigue or governance challenges can affect both bonds and currencies, sometimes abruptly.
- **Liquidity risk:** Some local, especially frontier, markets are less liquid, with wider bid offer spreads and more sensitivity to flows.

Most of these risks are highly differentiated by country, creating both pitfalls and opportunities.

FIGURE 8: 10-YEAR REAL EFFECTIVE EXCHANGE RATE TREND



Past performance does not predict future returns.

Source: BIS, JPMorgan, Bloomberg; as at 31 December 2025. Historical BIS EM REERs for individual EM currencies are weighted using current GBI-EM GD Index country weights. REER series are normalized to 100 at 31 Dec 2015. For illustrative and discussion purposes only. Nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. This material is not intended as a formal research report and should not be relied upon as a basis for making an investment decision. Investing entails risks, including possible loss of principal. Historical trends do not imply, forecast or guarantee future results. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed.

From Tactical Trade to Core Building Block

EMD LC will always feel less familiar than domestic European bonds. But it is precisely this difference—in growth drivers, inflation dynamics and currency exposure—that gives it such powerful diversification potential.

Today, the asset class combines:

- A clear EM growth premium and inflation convergence story
- Improving credit quality and a broadening investment-grade universe
- High nominal and real yields relative to both history and developed markets—providing a meaningful cushion against near-term volatility
- A more supportive macro and FX backdrop than in recent years, with country-level differentiation increasingly rewarding active management

For European institutional investors seeking to diversify euro fixed income, enhance real income and add new sources of return, EMD LC is, in our view, worth considering as a mainstream allocation rather than a peripheral, tactical investment. The current environment, for all its uncertainty, does nothing to weaken that case.

Accessed through an experienced active manager, it can be harnessed in a disciplined way, transforming an often misunderstood segment of fixed income into a durable contributor to long-term portfolio risk-return outcomes.

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Neuberger Berman
The Zig Zag Building
70 Victoria Street
London, SW1E 6SQ
United Kingdom

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