

The Merits of Emerging Market Sovereign Bonds

Comparing Hard and Local Currency Debt

September 2025





Increasing concerns about the deterioration in a number – but not all – developed world government balance sheets, together with increasing concerns about so called "fiscal dominance" over monetary policy has encouraged investors to reconsider the composition of their fixed income portfolios and look at emerging markets (EM) in a new light. We at Colchester have argued for some time that relative balance sheet strength, sustained adherence to policy orthodoxy, the shift to predominately domestic funding, and the potential return on offer in a number of emerging markets has increasingly made them attractive relative to their developed world counterparts and other sectors of the fixed income market. However not all "emerging markets" are alike. Today, many investors and commentators still apply the blanket term "emerging markets" to loosely define all those countries not in the "developed world". In our opinion this is a misnomer. It is no longer appropriate to throw solidly investment grade countries like the Czech Republic, Poland, or Chile into the same bucket as below investment grade countries like Pakistan, Venezuela, or Uganda. Today the former, and others, are more like a number of traditional developed markets, while the latter are "frontier markets" possessing characteristics similar to the "emerging markets" of the 1980s and 1990s that spawned the Tequilla Crisis, Asian Financial Crisis, and other shocks that investors associate with emerging markets. In many respects, today's frontier markets are the emerging markets of yesteryear.

It should be apparent that much like the difference between investment grade corporates and high yield in credit space, there is similar differentiation within emerging markets. Broadly speaking the emerging market fixed income universe can be divided into exposure to debt issued in local currency and that issued in hard currency, predominately US dollars. In the local currency space, investors may access either:

- (i) The higher quality investment grade end of the local market spectrum, and/or
- (ii) Local currency bonds in the frontier space, via separate dedicated local currency benchmarks.

On the other hand, the hard currency benchmarks tend to group all emerging markets into one, encompassing AA countries at one end, to single C rated ones at the other end of the credit spectrum. Unsurprisingly, the structural characteristics of the countries comprising each benchmark, their credit quality, and potential risk and return all differ across the three alternatives – EM local, Frontier local, and hard currency EM. Focusing on EM local and EM hard currency government debt we explore these differences, consider their potential role within a diversified policy mix, and assess current valuations in this paper.

The Role of Emerging Market Debt in a Diversified Portfolio

All investors, to varying degrees, need to balance and trade off three objectives, namely safety, liquidity, and return. Their particular circumstances, objectives and risk tolerance will each play a role in the asset allocation decision of where to invest. For example, in the case of a central bank or reserve manager, liquidity and safety are likely to be paramount, so domestic and global developed market debt are likely to form the core of their portfolio. However, other asset classes have historically offered higher return potential and thus may also find a place in the asset allocation, taking account of their safety and liquidity characteristics. Other investors such as endowments, foundations or superannuation funds may place a higher weight on expected long-term returns, but likewise some allocation to relatively safe and liquid assets is likely to improve the overall risk-return characteristics of their portfolios. Whilst the most basic asset allocation decision between equities and bonds remains core to portfolio construction today, investors also consider a wide variety of other asset classes from property, to emerging market debt, to private equity and private credit.

Each asset class increasingly needs to compete with others to fulfil a certain role within the overall aggregate portfolio. Asset allocators are increasingly becoming aware that the diversification and potential risk and return characteristics of EM debt makes it a potentially interesting addition to their aggregate portfolio mix. Local currency EM debt may not only compete



against investment grade corporates and high yield for space in that portfolio but also is increasingly being considered as a dedicated allocation in place of some traditional developed market (DM) fixed income exposure given its credit rating, relative balance sheet strength, and return potential. In contrast, given its predominately US dollar orientation and lower credit quality, hard currency EM debt typically competes with High Yield and other higher risk or total return orientated sectors for space in an aggregate portfolio. Whilst some still fall into the trap of deeming local and hard currency EM as the same, the underlying characteristics, credit quality, and currency exposure suggest that they are not.

Whilst a clear case can be made to treat both local and hard currency EM debt differently, many still compare the two as alternatives. Accordingly, any discussion needs to assess the respective merits of both. With that in mind, Colchester believes that local currency EM government debt is particularly attractive today for both strategic (in terms of capital preservation, liquidity, and return) and tactical (it offers attractive valuations at this juncture) asset allocation reasons. In contrast, while hard currency EM sovereign debt has historically generated attractive returns, its characteristics are less conducive to the objectives of safety (i.e., capital preservation) and liquidity, given its lower credit ratings and poorer liquidity. Furthermore, in our opinion, current valuations of the hard currency EM debt asset class are less attractive than those prevailing in local currency space. This is in part due to the current overvaluation of the US dollar that those hard currency bonds are denominated in. For an Australian dollar based investor, the US dollar appears to be meaningfully overvalued and hence allocating to US dollar-denominated securities incurs a potential return headwind from the currency exposure. In contrast, a variety of local EM currencies (including the likes of the Brazilian real, Indonesian rupiah, and the South African rand) offer compelling (real) currency value versus both the Australian and US dollars. This indicates potential for positive future currency returns as these currencies appreciate towards fair value.

Table 1. Long-term asset class returns (30 Sep 2015 – 30 September 2025)¹

	Annualised Return	Annualised Volatility	Risk-Adjusted (Return/Volatility)
Global Equities	13.08%	11.07%	1.18
Global Equities (AUD Hedged)	12.03%	14.01%	0.86
US High Yield Debt (AUD Hedged)	5.35%	7.64%	0.70
Hard Currency EM Debt	4.73%	8.28%	0.57
Local Currency EM Debt	4.14%	8.10%	0.51
Australian Corporate Debt	3.30%	3.04%	1.09
Hard Currency EM Debt (AUD Hedged)	3.38%	9.20%	0.37
US Corporate Debt (AUD Hedged)	2.40%	6.69%	0.36
Local Currency EM Debt (AUD Hedged)	2.38%	4.00%	0.60
Australian Government Bonds	1.66%	5.60%	0.30
Global Investment Grade (IG) Government Debt (AUD Hedged)	1.40%	4.26%	0.33
US Treasuries (AUD Hedged)	0.82%	4.90%	0.17

Source: Bloomberg. Returns in AUD unhedged terms unless stated otherwise.

¹ MSCI World 100% Hedged Net Total Return AUD Index, Intercontinental Exchange (ICE) Bank of America (BofA) US High Yield Constrained Index, JP Morgan Emerging Market Bond Index (EMBI) Global Diversified Index, JP Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified, Bloomberg US Aggregate Credit Total Return Index, FTSE World Government Bond Index (WGBI), FTSE US Government Bond Index (GBI), FTSE Australian Government Bond Index (GBI), Bloomberg AusBond Credit Index, Bloomberg AusBond Semi Government Index.



Historical Returns and Correlations

Table 1 presents a selection of fixed income asset classes with varying currency hedging profiles, which we believe represent the typical options available to Australian asset allocators. Historically both EM hard and local currency debt have generated meaningfully higher returns than traditional defensive fixed income assets such as US Treasuries, albeit with higher volatility (see Table 1). Both asset classes have also outpaced Australian Government Bond returns over the longer-term. The local currency asset class has also comfortably outperformed global developed market government debt over the longer-term. Hard currency debt has performed well over the period, although it delivered lower returns than US high yield corporate debt and came with higher volatility. Unhedged local currency EM debt returns exhibited a historical volatility of 8.1%, slightly less than that of unhedged hard currency EM debt at 8.3% over the period. The volatility of local currency debt in hedged terms at 4.0% has been meaningfully below that of hard currency debt at 9.2% and had the second lowest volatility over the period amongst the asset classes we examined in Table 1. Finally, local currency EM debt has delivered relatively attractive risk-adjusted returns, both in hedged and unhedged terms.

The relevance of volatility per se depends on the objective and risk tolerance of the individual investor. For most investors the risk of permanent loss is probably more important than simple price volatility. As noted above, hard currency debt contains more outright credit risk than local currency debt and therefore exposes investors to a higher probability of default. That credit risk needs to be traded off against the potential return.

As well as the return profile, the relationship or correlation between different fixed income sectors - and therefore potential diversification benefits - should also be considered at the aggregate portfolio level. Table 2 suggests the diversification benefits of local currency EM debt are superior to that of hard currency EM debt, given its historically lower correlation to Australian Government Bonds, Australian investment grade corporate debt, US Treasuries, and US high yield corporate debt. Given the intrinsic characteristics of the two EM debt asset classes, this result is to be expected. Hard currency bonds are typically held by global investors and are valued and priced by the market as a credit spread relative to/over the US Treasury curve (as USD-denominated debt comprises the majority of this asset class). Local currency EM bond markets on the other hand, are typically bought by domestic investors and are therefore less sensitive to changes in global financial conditions and more sensitive to domestic economic conditions.

Table 2. Historical return correlations of fixed income sectors (30 September 2015 – 30 September 2025)²

	Local Currency EM (Unhedged)	Hard Currency EM (AUD Hedged)	Australian IG Corporate Bonds (Unhedged)	US High Yield (AUD Hedged)	Australian Government Bonds (AUD Hedged)	US Treasuries (AUD Hedged)
Local Currency EM (Unhedged)	1.00					
Hard Currency EM (AUD Hedged)	0.39	1.00				
Australian IG Corporate Bonds (Unhedged)	0.44	0.55	1.00			
US High Yield (AUD Hedged)	0.20	0.85	0.50	1.00		
Australian Government Bonds (AUD Hedged)	0.29	0.53	0.77	0.38	1.00	
US Treasuries (AUD Hedged)	0.19	0.41	0.67	0.22	0.92	1.00

Source: Bloomberg.

² FTSE Australian GBI, JP Morgan GBI-EM Global Diversified Index, JP Morgan EMBI Global Diversified Index, Bloomberg AusBond Credit Index, ICE BofA US High Yield Constrained Index, FTSE US GBI.



Whilst it is important to understand historical returns and correlation behaviour, historical performance is not necessarily indicative of future performance. The returns generated from investment in any asset can be heavily dependent on the valuation of the asset class in question at the outset. That is to say, the starting point matters. The back-up in yields in response to the post-COVID inflation shock has seen interest rates in all fixed income sectors broadly reset at higher levels, more in line with historical norms. While investors are once again being "paid" to own bonds, the relative attractiveness of different sectors varies. Most notably credit spreads have fallen to multi-year lows in the likes of the US, UK, and Europe in the third quarter of 2025. This suggests that some caution may be warranted in those sectors that are priced as a spread relative to the underlying sovereign. That includes corporate debt, high yield, and EM hard currency debt. Some of those sectors' historical absolute and relative performance reflects the spread compression that has occurred, and the relative strength of the US dollar compared to the non-US assets that comprise a larger proportion of the global indices and local currency EM debt indices presented in Table 1. *A reversal of either of these drivers is likely to have a significant impact on relative returns going forward.* Moreover, an Australian investor who does not hedge their currency exposure could benefit from potential gains in EM local currencies, which are currently undervalued relative to the Australian dollar. They may be expected to gain from the appreciation of those local currencies against the Australian dollar. On the other hand, investing in EM hard currency debt (denominated in US dollars) may lead to currency-related losses, as the US dollar is considered overvalued relative to the Australian dollar. In this scenario a fall in the US dollar versus the Australian dollar would impact negatively on returns. As noted above asset allocators not only need to consider potential returns, but they also need to consider capital preservation, credit ratings, and liquidity.

1) Capital Preservation and Liquidity

Starting with the safety – or capital preservation – characteristics of local and hard currency EM debt:

Default Probability

Table 3 shows the historical default rates over the last 50 years of EM sovereign debt in both local and foreign currency, and by credit rating:

Table 3. Sovereign Cumulative 5yr Average Default Rates (1975-2024)

Rating	Foreign Currency	Local Currency
AAA	0.00	0.00
AA	0.00	0.00
A	1.09	1.04
BBB	2.44	1.28
BB	3.74	2.04
B	17.36	8.35
CCC/CC	49.23	33.08

Source: Default, Transition and Recovery: 2024 Annual Sovereign Default and Rating Transition Study, Standard and Poor's, 2025.

Local currency debt has had a lower default rate across the board. Intuitively we would have expected this. Sovereign issuers typically have the unique ability to create (or "print") the currency of denomination of the bond, as well as an ability to raise taxes from their domestic economies to meet financing and servicing needs. Governments also face pressure from their local population, who vote, or implicitly have the power to remove those in government. It is therefore not surprising that, as most local currency EM debt is held domestically, there is a greater willingness to default on foreign rather than domestic creditors at a point of stress. These factors make hard currency EM debt more vulnerable to default, and the historical experience bears this out.



When examining defaults and exploring why foreign currency defaults are so much higher, it is probably worth considering why governments issue debt in a foreign currency. As an individual if you were to borrow money, say to purchase a house, you would earn money in your local currency, buy the house in your local currency, and you would almost undoubtedly borrow the money in your local currency. Borrowing money in a foreign currency might enable you to obtain a lower interest rate, but you would also take on the risk that the exchange rate could move, and this risk will nearly always be much higher than any saving on the interest rate could justify. The same is true for governments; by borrowing in a foreign currency, they are taking on substantial currency risk, so why would they do this?

The emerging markets universe is made up of two types of countries, those that have a "natural" hedge against foreign currency risk, and those that do not. For example, Saudi Arabia and Qatar are in the EM hard currency index and borrow in US dollars. Both countries have pegged their currencies to the US dollar as their main exports, oil and gas, are priced in US dollars. They may have borrowed in Dollars, but they also have a "natural hedge" as the majority of their revenue is directly linked to the US dollar. On the other hand, there are countries like Argentina and Egypt that borrow in US dollars. They fall into the second category as these countries have little in the way of a natural hedge. So why do they do it?

Essentially the answer is that in a country where the financial system is not well developed, the government often struggles to raise the necessary finance that it needs domestically. This means it is forced to borrow from international investors, and they often want to lend in US dollars. Once a country has borrowed in a foreign currency, they are vulnerable to large currency moves where their domestic currency falls against the US dollar. When this happens, it reduces their ability to repay their foreign debt. Historically, when a country has defaulted on its foreign debt, it has often been preceded by a steep fall in the value of the domestic currency. Normally there are other fundamental problems in the country that may contribute to the weakness in the currency, but it is the currency devaluation that typically forces the default.

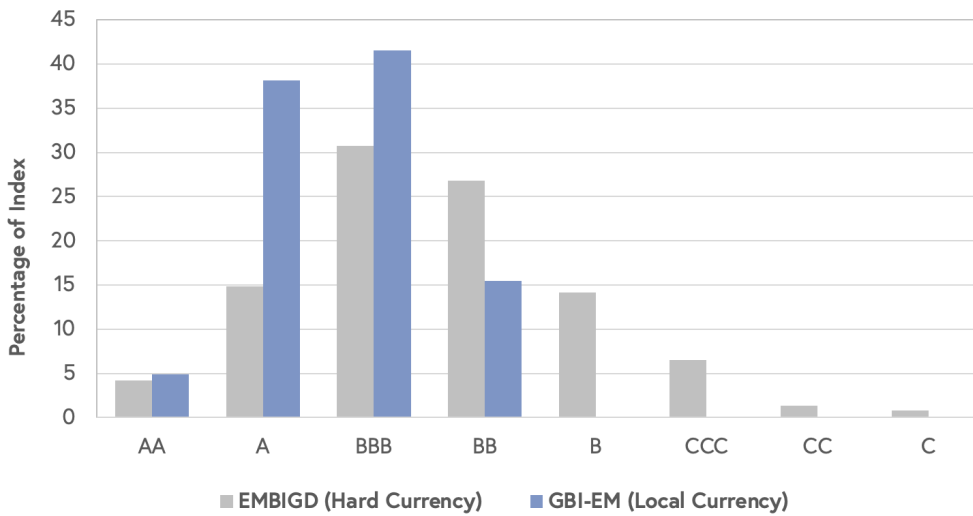
2) Credit rating

Given this higher default probability on hard currency EM debt, asset allocators need to be aware of the different rating profiles of both EM fixed income sectors when comparing the two. Not only is the probability of default lower in local currency debt, the credit rating of the standard local currency EM index (JP Morgan GBI-EM Global Diversified) has a demonstrably higher rating profile than its hard currency counterpart (JP Morgan EMBI Global Diversified). This difference is clear in Chart 1. The higher credit ratings enjoyed by EM local currency debt is not surprising as economies with more stable currencies and inflation, as well as deeper domestic capital markets, tend to issue more debt domestically rather than in hard currency in international markets. Many of the countries included in the local currency index issue around 90% of their debt in local currency. By issuing in their local currency, default risk is reduced, and this is rewarded by the credit rating agencies with higher ratings. Chart 1 clearly shows that the vast majority of the local currency index - some 85% - is currently rated investment grade, whereas the hard currency index has only 49.7% at the investment grade level and a "trail" of lowly rated countries in the index.³ This is where the credit rating and default probability intersects.

³ As at end September 2025.



Chart 1. Credit Rating Profile of Local and Hard Currency Indices⁴



Source: JP Morgan, Bloomberg. As of September 2025.

3) Liquidity

Liquidity is the final characteristic asset allocators need to consider. When we compare the depth and liquidity of each market, we observe that the local currency universe is significantly larger and more liquid. Currently, the market value of EM local currency government debt is estimated by JP Morgan to be around USD13 trillion, whereas the stock of hard currency debt is estimated at only USD1.5 trillion.⁵ This large and widening discrepancy is not surprising as countries have an incentive to reduce their external vulnerability by developing local capital markets and issuing in domestic currency. This reduces their exposure to external shocks, the risk of a capital flight and a potential shortage of foreign currency to meet funding needs. The three largest issuers of government debt within the EM universe - China, India, and Brazil - each issue more than 90% of their government's debt in their respective local currencies.

As EM countries increase their income levels and governance standards, they issue local currency government debt and foreign investors typically enter their market. This leads to an increase in the potential investable universe and improves liquidity. Once a country's local currency yield curve is fully developed and the appropriate bond settlement practices are setup, index providers would typically then consider them for inclusion in relevant benchmarks. When this happens, both demand and the liquidity profile typically increase. The inclusion of India in the local currency JPM GBI-EM index in 2024 is a good example of this evolution (see Box).

Unsurprisingly, given the larger issuance in local currency there is greater liquidity and lower bid-ask spreads in the local compared with hard currency EM debt markets. For example, in our experience, weighted average bid-ask spreads in the local currency universe are around 0.30 (as a percent of price) whereas they are around twice that in the hard currency investment universe.⁶ Furthermore, there is a tendency for dealing costs to increase more in the hard currency universe at times of stress. For example, spreads widened more in hard currency space at the time of the so-called "Liberation Day" tariff shock in the US in April 2025. Some may find this surprising, but for those countries that have developed their own capital markets and encouraged a savings industry, the risk-free asset for domestic investors is their own government bonds. It follows that the risk-free asset for a Thai or Mexican pension fund is not the US Treasury but rather is Thai or Mexican government bonds issued in their local currencies respectively. The consequent intrinsic demand for these securities underwrites the local market, provides liquidity, and keeps bid-ask spreads in check.

⁴ The rating shown is the highest of S&P, Moody's, and Fitch, where available. The local currency rating is used for the JP Morgan GBI-EM GD and the foreign currency rating for the JP Morgan EMBIGD.

⁵ JP Morgan as at end of December 2024.

⁶ As at the end of December 2024.



The Inclusion of India in the JPM GBI-EM Global Diversified Index

In 2024 India was included in the local currency EM government bond index, adding the fifth largest economy in the world to the benchmark. This added further liquidity to the local currency market as foreign investors were drawn into the market. It also enhanced the investment grade characteristics of the benchmark as India was BBB- rated at the time by the three main rating agencies.⁷ India's weight in the index built up from a small initial percentage at inclusion in June of 2024 and is now at its full 10% weight in the benchmark.⁸ This now means that six out of the twenty largest economies in the world are now in the JP Morgan GBI-EM global diversified index. Saudi Arabia is also looking to be included in the local index. Should that occur, it would take the number to seven.

Not only does India add another large economy to the index, it also adds to the diversification within the index. The Indian market not only has a low correlation with developed bond markets and risk assets, but it also has a comparatively low correlation with other countries in the EM universe. In fact, over the last ten years ending 2024, the correlation of Indian bonds (hedged into Australian dollars) with Australian Government Bonds and Australian Corporate Debt was only 0.30. The table below shows the correlation of Indian bonds with other major bond markets in the local currency index, as well as with the aggregated index itself. It is readily apparent that historical correlations have been low across the board. This suggests the addition of India probably increased diversification within the index and enhanced the opportunity set for active managers like Colchester to potentially generate alpha.

Table 4. Correlation Between INR denominated Indian Government Bonds and Other Local Currency Bond Markets

	India	Brazil	Mexico	Indonesia	Thailand	Poland	China	Türkiye	Colombia	Malaysia	GBI-EM
India	1.00										
Brazil	0.26	1.00									
Mexico	0.19	0.36	1.00								
Indonesia	0.18	0.36	0.58	1.00							
Thailand	0.30	0.35	0.66	0.51	1.00						
Poland	0.29	0.14	0.50	0.34	0.53	1.00					
China	0.19	0.09	0.05	-0.03	0.28	0.10	1.00				
Türkiye	0.01	0.24	0.16	0.29	0.18	0.01	0.06	1.00			
Colombia	0.23	0.41	0.55	0.52	0.49	0.43	-0.04	0.16	1.00		
Malaysia	0.18	0.31	0.59	0.55	0.74	0.54	0.25	-0.01	0.38	1.00	
GBI-EM	0.28	0.54	0.73	0.73	0.74	0.62	0.16	0.32	0.69	0.68	1.00

Source: JP Morgan, Colchester Global Investors. Returns are in AUD-hedged terms and for the 10 years to end September 2025.

Relative Valuations: Hard versus Local Currency

The structural characteristics of an asset class need to be balanced with the valuation on offer when considering the merits, or otherwise, of its inclusion in the overall portfolio asset allocation mix.

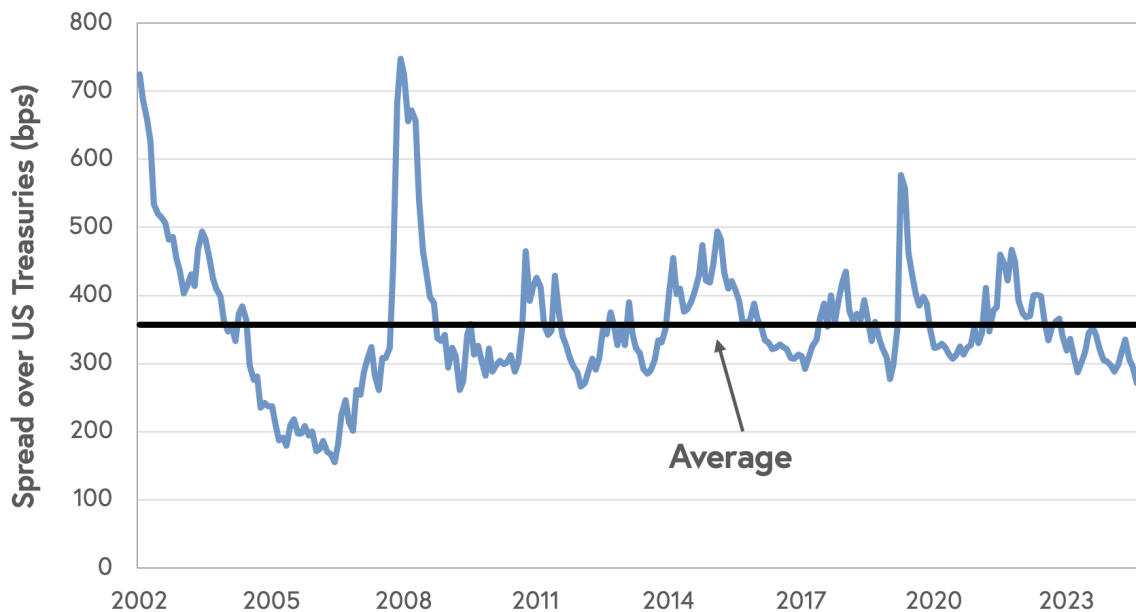
⁷ India was subsequently upgraded to BBB by Standard & Poor's on 14 August 2025.

⁸ As at September 2025.



When valuing hard currency EM debt there are two components that make up the valuation. As most of these bonds are issued in US dollars and priced against US Treasuries, the first component is the valuation of the underlying US Treasury bond. Of course, an investor can gain access to the US Treasury market without buying emerging market debt, so the component that really matters is the yield spread versus the government curve of the currency of issuance, and this is the primary valuation metric. As noted above, as most hard currency debt is issued in US dollars, the spread is typically assessed versus the underlying US Treasury curve. Chart 2 shows the spread of the EMBI index over US Treasuries since December 2002.⁹ The spread has averaged 357 basis points over this entire period and remarkably even if one ignores the swings in the spread associated with the mid-2000s valuation bubble that saw the spread fall to a low of around 150 basis points in mid-2007, and the subsequent rebound as the that bubble burst, the spread averaged 357 basis points in the post Global Financial Crisis (GFC) period from the end of 2010 to the end of September 2025. In other words, if one ignores this outsized volatility in the spread, the average is essentially the same as if one included it. In this context, it is perhaps surprising to see today's spread pushing the lower bounds of the last 15 years or so when the global growth outlook is particularly clouded given the potential negative impact of US tariffs, the likely resulting dislocation in supply chains, and uncertain inflation and interest rate outlook. Such an environment has not always been positive for lower-rated borrowers dependent on foreign capital. Whilst the same argument could be made about spreads and valuations across a range of credit sectors today, this suggests to us at least, that some caution is warranted in EM hard currency space as *history suggests valuations are on the expensive side*.

Chart 2. JP Morgan EMBI Global Diversified Index Spread and Average Level, December 2002 to end September 2025



Source: JP Morgan, Bloomberg, Colchester Global Investors. Month end data from December 2002 to September 2025. Please note the "spread" is over US Treasuries.

Currency Risk

The second factor asset allocators must consider when evaluating the value of hard versus local currency EM debt is the significant difference in currency exposure. Unhedged US dollar-denominated hard currency returns are influenced by movements in the Australian dollar against the US dollar, as the underlying assets are denominated in USD. In contrast, local currency EM debt returns in Australian dollar terms are driven by the movement in the diversified basket of emerging market currencies that comprise that opportunity set versus the Australian dollar.

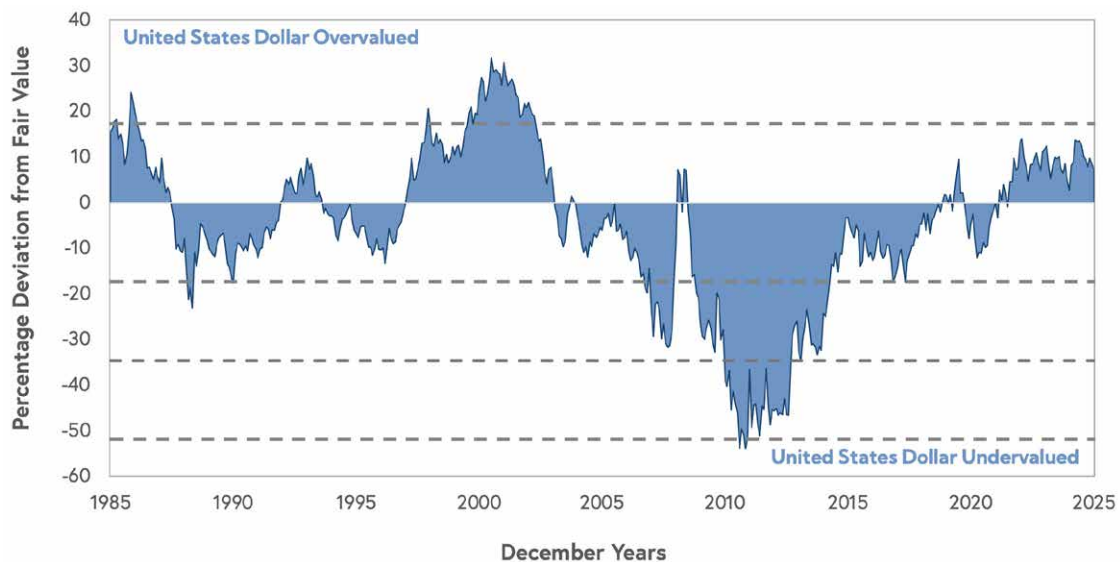
⁹ This is the commencement date of the equivalent JP Morgan GBI-EM Global Diversified local currency index.



Towards that end, Colchester's currency valuation framework is primarily driven by the real exchange rate, complemented by an assessment of a country's external balance sheet strength, institutional quality, governance, and other ESG factors, as well as the differential in short-term real interest rates. Despite the US dollar's depreciation since the end of 2024, our framework indicates that the US dollar remains meaningfully overvalued as of the end of September 2025. Colchester estimates that the US dollar reached a real overvaluation of close to 30% against an equally weighted basket of five major developed world currencies in late 2022. While its valuation relative to the Australian dollar is less extreme, a trend appreciation in the US dollar has persisted for over 15 years with minimal interruption (as shown in Chart 3). This suggests that the "super-cycle" in the US dollar may be drawing to a close, increasing the probability of a retracement toward fair value.

From the perspective of an Australian investor, we view the Australian dollar as moderately undervalued relative to the US dollar but overvalued against a diversified basket of EM local currencies. This suggests that, on average, EM currencies are likely to appreciate against the Australian dollar. In contrast, as noted above, the overvaluation of the US dollar suggests that US-denominated hard currency assets may face headwinds for Australian investors, as a weaker US dollar relative to the Australian dollar would negatively impact returns. In other words, there is a potential opportunity cost from investing in EM hard currency when the US dollar is at elevated levels, as investors may miss out on the benefits of a weakening US dollar. That said, a fall in the value of the US dollar could still provide some support to the hard currency EM index as a weaker dollar would, all else equal, ease debt servicing pressures for lower-rated issuers. However, with spreads already tight relative to historical norms, any improvement in credit spreads is likely to be marginal. As a result, the relative tailwind that has supported hard currency EM debt returns over the past decade is likely to reverse, with non-US dollar assets poised to outperform. This reinforces the importance of considering currency valuation — particularly the real exchange rate — as a key input when evaluating EM hard currency allocations.

Chart 3. Cycles in Australian Dollar Real Exchange



Note: The grey band represents multiples of the standard deviation, with the innermost bands representing 1 and -1 standard deviation.

Source: Colchester Global Investors, National Statistical Services CPI and PPI data, Bloomberg and WMR exchange rates. Data is as at end September 2025.

Local Currency Valuations

Turning to local currency EM debt, Colchester's investment framework breaks down the inherent value in local bond markets into two parts. For the bonds, the primary driver of our valuation is the prospective real (i.e., inflation-adjusted) yield. Then, as we are buying those bonds in their local currencies, we also value the currency.

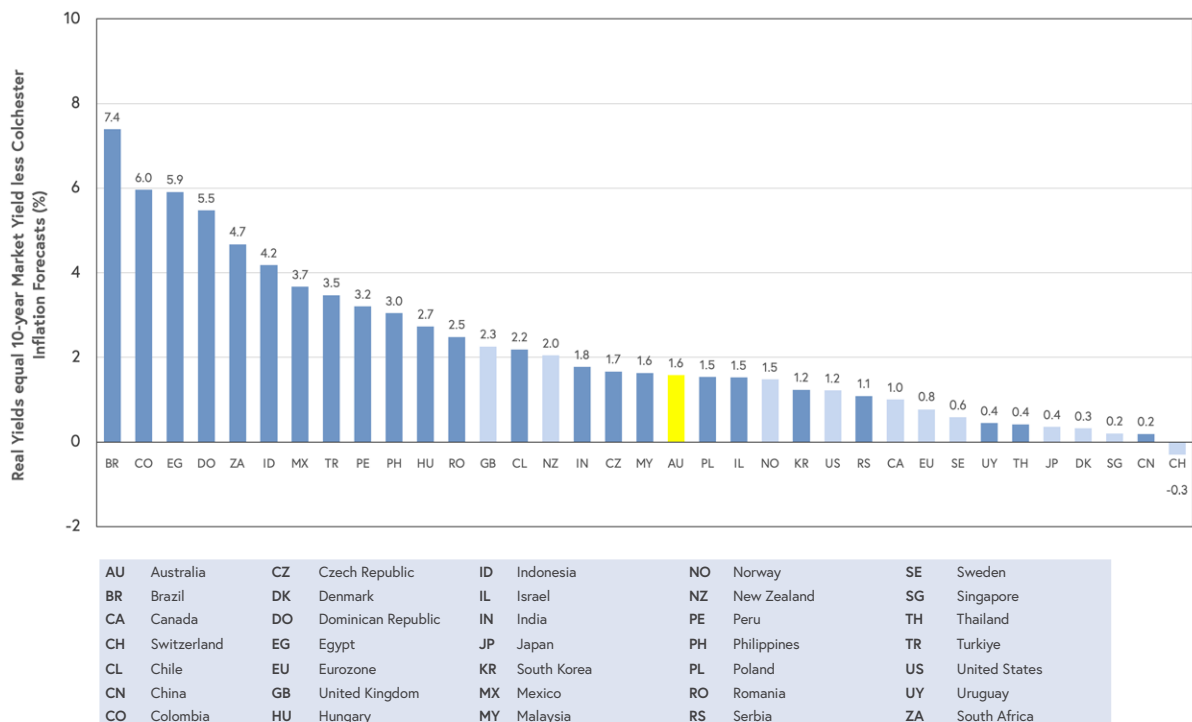


Starting with the bond valuations, historically, bond markets in those countries with higher relative real yields have generated better returns than those with lower real yields. Accordingly, after adjusting for the robustness, or otherwise, of a country's balance sheet, and the strength and quality of governance and other ESG factors, we are drawn to countries with higher (adjusted) real yields. As the future ex-post real yield is unknown, we focus on the outlook for inflation to determine our estimates of the ex-ante or "prospective" real yields on offer.

Towards this end, inflation in the emerging world was buffeted over the last 3 to 4 years by the same supply and demand shocks that the developed world was exposed to. Like elsewhere, there was a surge in inflation in response to the post-pandemic supply chain disruption, the subsequent demand shock driven by aggressive stimulus, and elevated food and energy prices. Latin America and Central Europe were particularly hard hit, while the experience in Asia was more mixed.¹⁰ As global inflation pressures have receded, inflation has declined in a number of emerging markets at a similar, if not faster, pace than that seen in the developed markets. Most notably the likes of Mexico, Indonesia, and South Africa have all experienced significant declines to comparatively low levels as inflation was brought under control.

Although the future inflation picture has been complicated by the US tariff situation, real interest rates remain high in a number of EM countries compared to those in the developed world. This makes those markets more attractive in both absolute terms and relative to their developed world counterparts, including the US bond market. This can be seen in Chart 4 showing Colchester's prospective real yield estimates as at the end of September 2025. It is evident that a diversified basket of EM bonds could be constructed comfortably offering a 4% prospective real yield, in contrast to the 1% to 1.5% on offer in the developed world. All else being the same this suggests EM bonds have greater potential to generate higher returns going forward than those in the DM universe.

Chart 4. Prospective Real Yields on Offer in the Emerging and Developed World as at end September 2025



Notes: 1. The prospective real yield for the 10 year sector is shown here for representational purposes. Colchester values up the 2, 5, 10 and 20 year sectors of the yield curve when valuing a country. The final portfolio reflects the value on offer in these individual yield curve points. 2. The expected real yield for Euroland is calculated based on the 10 year German Bund yield and the Colchester forecast for inflation in the Eurozone. 3. Source: Colchester Global Investors, individual Central Bank CPI and PPI data, and Bloomberg.

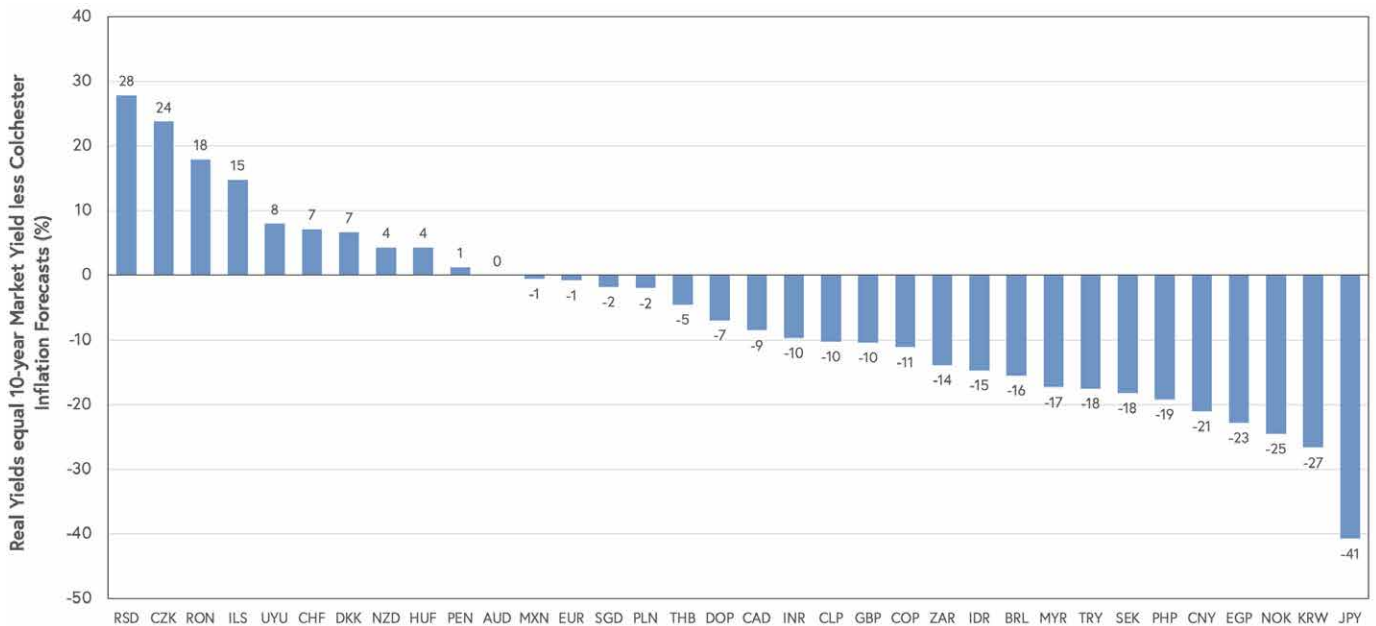
¹⁰ Inflation topped 25% in Hungary and rose to around 18% in Poland and the Czech Republic. The likes of Colombia, Brazil and Chile fared a little better, peaking somewhere between 12% and 14%, while Mexican inflation peaked in line with the US at around 9%. In contrast, Indian inflation hardly deviated from its norms, Chinese inflation peaked at 3% and Indonesian and South Korean inflation peaked around 6%. In comparison, Australian and Canadian inflation peaked around 8%, Swedish around 12%, the UK 11%, the Eurozone 10%, Norway and New Zealand 7%, and Japan 4%. Source: Bloomberg, inflation data measured between April 2022 and September 2025.



The second potential driver of returns is the currency element. As discussed above, if the basket of currencies associated with the foreign assets held (in this case local EM bonds and currencies) is expected to appreciate against the Australian dollar, then this provides a further structural tailwind for AUD returns in the EM local currency bond asset class.¹¹ The converse also holds true. When assessing EM currency valuations against the Australian dollar, it is therefore useful to consider where the Australian dollar currently is in the valuation cycle. If the Australian dollar is overvalued and expected to decline over the medium-term, then this will, all other things being equal, improve the AUD return potential of local currency emerging bonds/currencies.

Chart 5 shows real exchange rate estimates for both developed and emerging world currencies as at the end of September 2025. The chart clearly shows a variety of EM local currencies that are undervalued compared to the Australian dollar. This suggests an actively managed, diversified basket of EM currencies is more likely than not to appreciate against the Australian dollar over the medium-term, providing a potential return tailwind for (unhedged) EM local currency denominated assets. At the very least, it suggests that any positive bond returns being delivered by the higher real and nominal yields on offer on the bond side of the EM local currency debt asset class, are unlikely to be eroded by EM local currency weakness over the medium-term. Of course, an Australian dollar-based investor would be able to gain from a fall in the Australian dollar by holding foreign currency assets, but what is especially attractive about EM local currency bonds is that the underlying asset - the bonds - in our opinion are also attractively valued.

Chart 5. Real Exchange Estimates Versus the Australian Dollar as at end September 2025



AUD	Australian Dollar	CZK	Czech Koruna	IDR	Indonesian Rupiah	NOK	Norwegian Krone	SEK	Swedish Krona
BRL	Brazilian Real	DKK	Danish Krone	ILS	Israeli New Shekel	NZD	New Zealand Dollar	SGD	Singapore Dollar
CAD	Canadian Dollar	DOP	Dominican Peso	INR	Indian Rupee	PEN	Peruvian Sol	THB	Thai Baht
CHF	Swiss Franc	EGP	Egyptian Pound	JPY	Japanese Yen	PHP	Philippine Peso	TRY	Turkish Lira
CLP	Chilean Peso	EUR	Euro	KRW	Korean Won	PLN	Polish Zloty	UYU	Uruguayan Peso
CNY	Chinese Yuan	GBP	British Pound	MXN	Mexican Peso	RON	Romanian Leu	ZAR	South African Rand
COP	Colombian Peso	HUF	Hungarian Forint	MYR	Malaysian Ringgit	RSD	Serbian Dinar		

Source: Colchester Global Investors, individual Central Bank CPI and PPI data, Bloomberg and WMR.

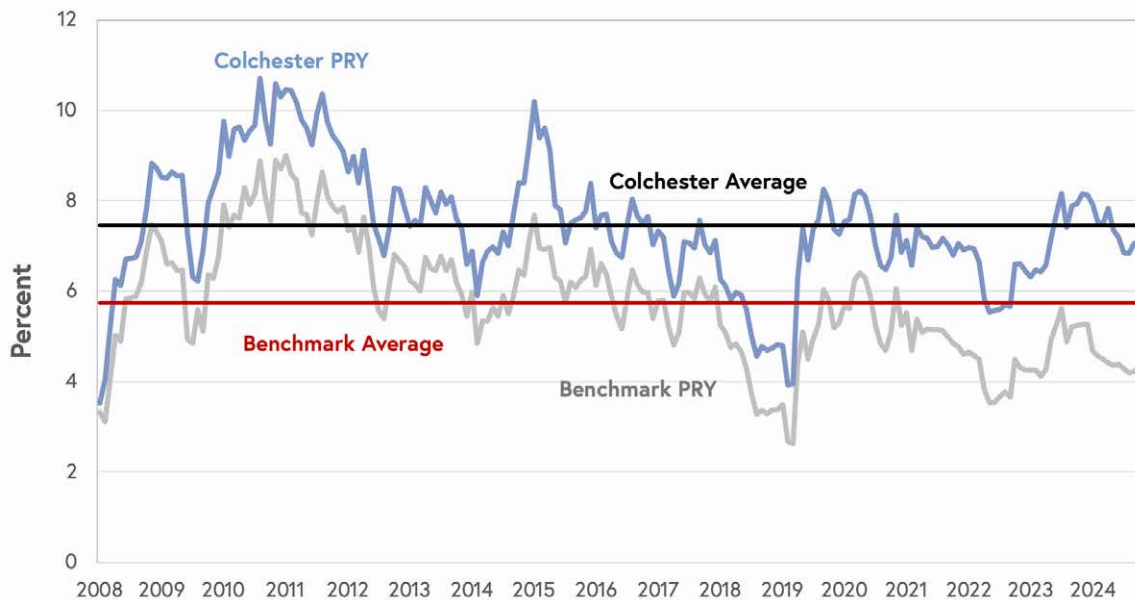
¹¹ If all foreign assets are hedged back into the domestic currency, then the potential for positive or negative currency returns is negated.



Chart 6 shows a combined valuation metric for the EM local currency bond index (the JP Morgan GBI-EM Global Diversified) and for Colchester's portfolio over time. The bond element is simply the weighted average prospective real yield. In other words, the nominal yields in each market adjusted for Colchester's forecast of future inflation. The currency element is the weighted percentage over- or undervaluation in real terms relative to the Australian dollar, divided by -5.¹² The over- or undervaluation is estimated by calculating the real exchange rate for the currency and comparing that to a measure of long-term equilibrium or "fair value".

Combining today's bond and currency valuations in Chart 6 suggests that local currency EM debt is attractively valued near the long-term average since we launched our EM local currency debt program in 2008. We estimate the value on offer is approximately two thirds from the bond portfolio and one third from the currency portfolio.

Chart 6. Combined Bond and Currency PRY Valuations



Source: JP Morgan, Bloomberg, Colchester Global Investors. Data from December 2008 to September 2025. Black and red lines show the respective averages over the period.

Balance Sheet Considerations

Finally, investors need to consider whether their investments are "money good" (i.e., will they be repaid). Towards that end, we at Colchester evaluate the strength of a country's fiscal balance sheet and related factors to assess both the value on offer in their bond market and to determine the sustainability of their debt and deficit profile. An assessment of the external balance sheet also highlights any vulnerabilities that may pressure the currency.

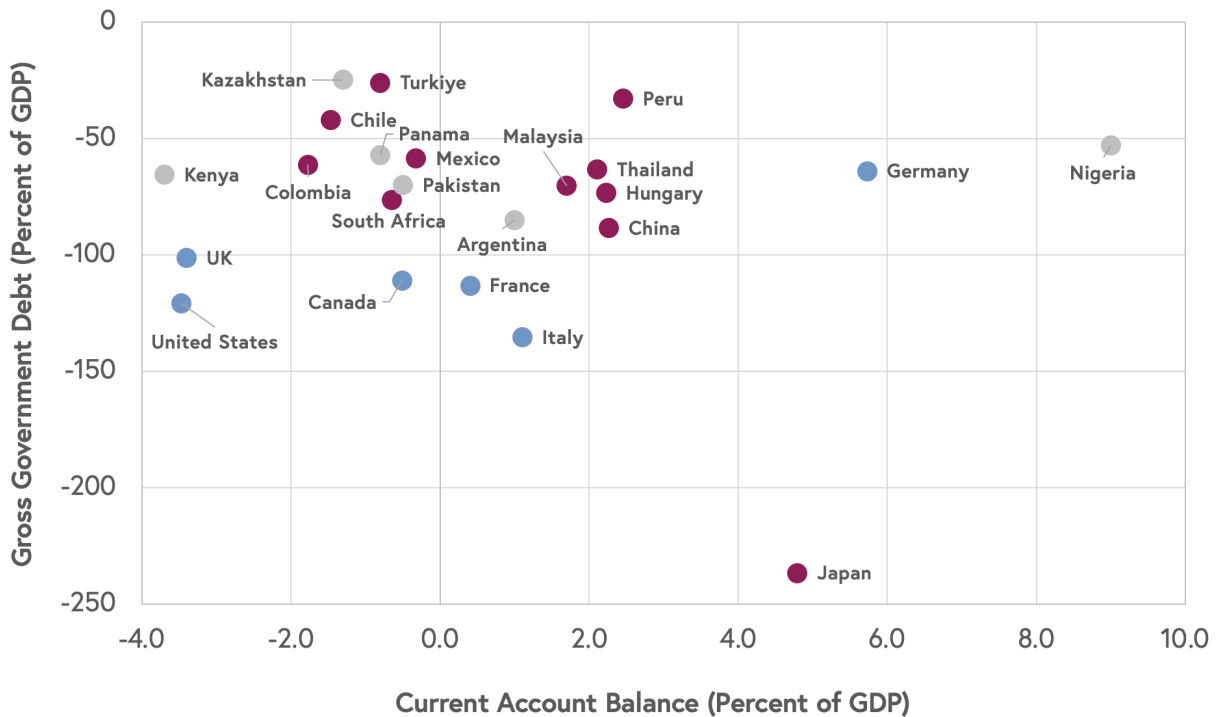
Overall, the local currency bond universe has stronger fundamentals than many of its developed world counterparts. A simple aggregated measure combining both a country's government debt level and current account provides a useful insight into its overall balance sheet strength. The level of government debt provides an insight into a country's historical fiscal profligacy or prudence, its capacity to cushion shocks, and its ability to repay its debt. Similarly, the current account provides

¹² The historical evidence suggests on average there is a 5 year mean reversion process. Accordingly, by dividing by -5 we translate the over or under valuation into an average expected change in the exchange rate. For example, if a currency is 10% undervalued relative to the AUD, we translate that into a positive exchange rate change expectation of 2% (i.e. -10%/-5). Empirical studies suggest that on average there is a 5-year mean reversion to fair value in the real exchange rate, hence dividing by -5.



insight into a country's ability to fund itself, the need for foreign capital, and the accumulation of foreign liabilities. While there are many dimensions and layers to assessing the strength or otherwise of a country's balance sheet, Chart 7 provides a useful snapshot. It shows these two measures plotted on a scatter graph for a selection of major countries in the local currency emerging market index, some in the hard currency index, and the G7 countries.

Chart 7: Gross Government Debt Against Current Account Position



Source: IMF, Colchester Global Investors. Data as at December 2024.

The local emerging market countries are shown in red, and they tend to be towards the top of the chart, which means that they are relatively less indebted. The grey countries are some of those that are in the hard currency EM index and have broadly a similar picture. Only Germany of the developed countries has comparable government debt levels to many in the EM world, with the other developed world countries having significantly higher debt levels. The current account position is slightly more nuanced, with most EM countries generally sitting within a +/-2% band, Frontier countries tending to run larger deficits (given their need for capital at this stage of their development), and G7 countries showing considerable dispersion with the US and the UK in particular consuming notably more than they make relative to the rest of the world.

These conclusions are consistent with the patterns we have seen emerge since the GFC. Namely less fiscal prudence and policy orthodoxy in the developed world relative to the EM world, leading to a faster build-up of debt in those countries. This has translated into structurally better balance sheets in the EM relative to those in the DM world. Within our investment framework this improves the relative value of EM versus DM markets as relative balance sheet strength provides them with greater capacity to withstand and cushion shocks like the 2025 tariff shock currently rolling across the globe. This enhances the real yield (or PRY) advantage discussed above and reduces the likelihood of balance sheet issues undermining any potential currency appreciation gains.



Conclusion

To conclude, we believe that asset allocators need to weigh up the return, liquidity, and safety characteristics of different asset classes. Local and hard currency EM government debt both offer attractive historical returns and diversification benefits relative to core fixed income but should also be considered distinct asset classes. Local currency EM debt in our opinion offers structurally higher liquidity and lower credit risk for the reasons outlined in this paper. The diversification benefits are also somewhat better, and the investment grade nature of the asset class is increasingly seeing it compete with investment grade corporates, and at the margin DM debt, for space in diversified aggregate portfolios. Global factors tend to have more of an influence on hard currency debt markets while domestic drivers tend to impact more on local currency debt markets.

In our opinion, the cyclical outlook currently favours local currency EM debt. Hard currency debt and other credit sectors currently have low yield spreads relative to history, while valuations in local bond markets look attractive, especially when combined with the Australian dollar's current overvaluation against most EM local currencies. Should these currencies continue to adjust back towards fair value this should provide a significant return tailwind for local currency EM debt going forward. Similarly, the structural improvements in a number of emerging market countries' balance sheets over the past couple of decades has been reflected in notable improvements in credit ratings in the sector. This has significantly improved their attractiveness relative to a number of developed world economies where government balance sheets are increasingly looking stretched, and policy constrained. These EM markets no longer exhibit the historical characteristics of "emerging markets", whereas frontier markets are better thought of as those markets today.

In summary, we believe that the attractive real yields on offer, meaningful currency undervaluation relative to the Australian dollar, and the relative strength of EM balance sheets make local currency emerging market debt a compelling investment proposition in the current environment.



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