



Global Investment Research | Multi-Asset

Emerged: The structural re-rating of Emerging Markets

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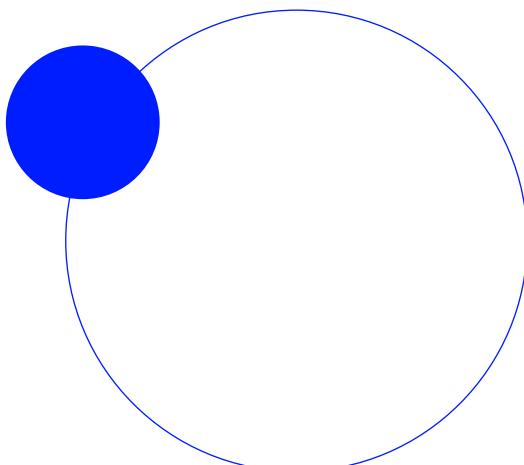
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Highlights

- In the last 25 years, emerging markets (EMs) collectively have meaningfully reduced their macroeconomic and financial market vulnerabilities, through stronger policy frameworks, improved external balances, and deeper domestic financial markets. EM vulnerabilities today are more likely to be idiosyncratic and localized.
- These structural improvements have, over time, prompted a gradual positive re-rating of EM assets, starting with sovereign fixed income and FX markets many years ago, and more recently observed in equities, where in 2025 EMs outperformed developed markets (DMs).
- EM equities potentially offer compelling upside opportunities relative to DM equities, benefitting from several secular investment themes that have been driving equity markets recently, including AI investment, the green transition, soaring demand for certain industrial and precious metals, and rising spending power in EMs, that all likely have room to run.
- EM equities are also likely to benefit from more cyclical factors such as having larger fiscal head room, a more independent monetary easing cycle, attractive valuations, better earnings growth outlooks and lower correlations relative to DMs.
- Portfolio allocations to EMs deserve another look. EM equity market capitalization relative to global equities peaked post-GFC in October 2010 at around 13% and was 10.2% at the end of 2025. Emerging markets and developing economies' share of global GDP is estimated by the IMF at 41% (2025) and expected to rise to 44% (2030).
- There is considerable variation among EMs, with distinct macro and market drivers. EMs may lend themselves well to investors seeking selective, granular portfolio exposures.



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Introduction

In the years since the Asian Financial Crisis, emerging markets (EMs) have meaningfully reduced their macroeconomic and financial market vulnerabilities in many ways, through stronger policy frameworks, improved external balances, and deeper domestic financial markets. These structural improvements have, over time, prompted a gradual positive re-rating of EM assets by global financial markets. Importantly, this re-rating has unfolded sequentially across asset classes.

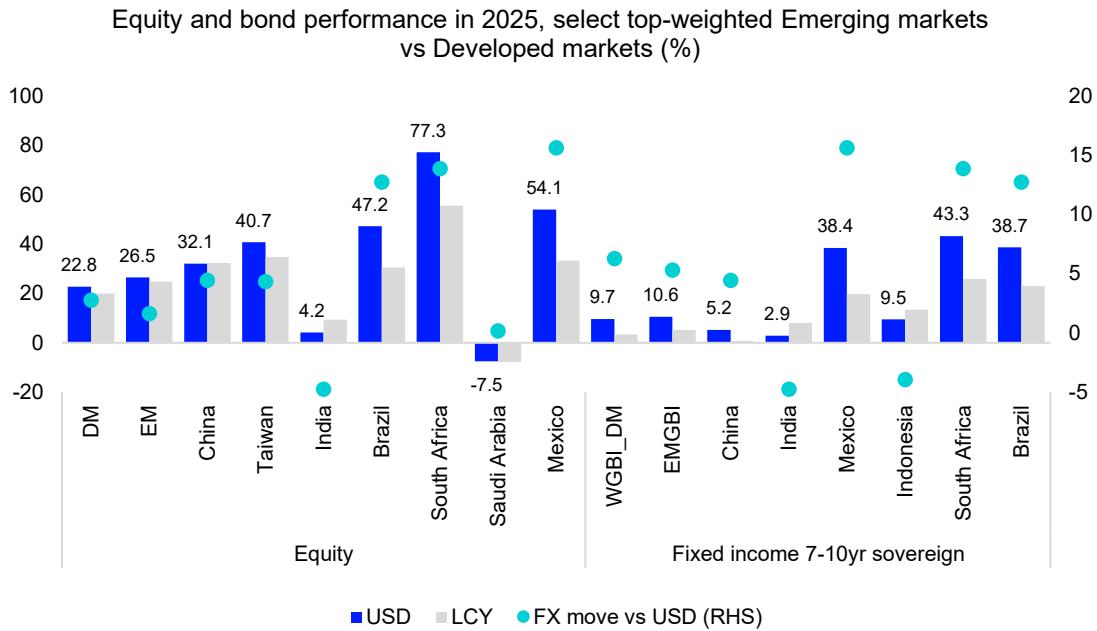
It first became evident in sovereign fixed income, where yield spreads versus developed markets (DMs) compressed markedly, reflecting improved debt sustainability and greater policy credibility. The repricing then extended to foreign exchange markets, supported by stronger macro fundamentals and more effective inflation control via independent monetary policy implementation. By 2025, this positive reassessment of EMs has increasingly been observed in equities, with EM equities outperforming their DM counterparts, driven by multiple countries and sectors, reflecting broad-based rallies rather than heavy reliance on one single dominant industry like Technology for the US.

This sequencing of EM re-rating – fixed income first, followed by foreign exchange, and then equities – is consistent with the differing sensitivities of asset classes: fixed income primarily prices downside risk and repayment certainty, while equities reflect upside potentials and longer-term growth and earnings expectations. In this research piece, we examine these dynamics through a structured set of questions and answers in five sections, providing a clear and engaging framework to explore how and why EMs' risk-return profiles have evolved across asset classes.

Question 1: How did EMs perform across equities, fixed income, and foreign exchange in 2025, relative to DMs?

EM equities weathered US tariff shocks and outperformed their DM counterparts in 2025, marking a notable departure from historical patterns in which EM equities generally lagged DMs, often by a wide margin. This reversal highlights a meaningful shift in relative performance dynamics and underscores the changing macro and market backdrop within emerging economies. Beyond equities, EM strength was also evident in fixed income and FX markets, where improved fundamentals and policy credibility reduced perceived downside risks.

Exhibit 1: EMs outperformed DM counterparts in both equity and fixed income in 2025, with sizable FX gains.



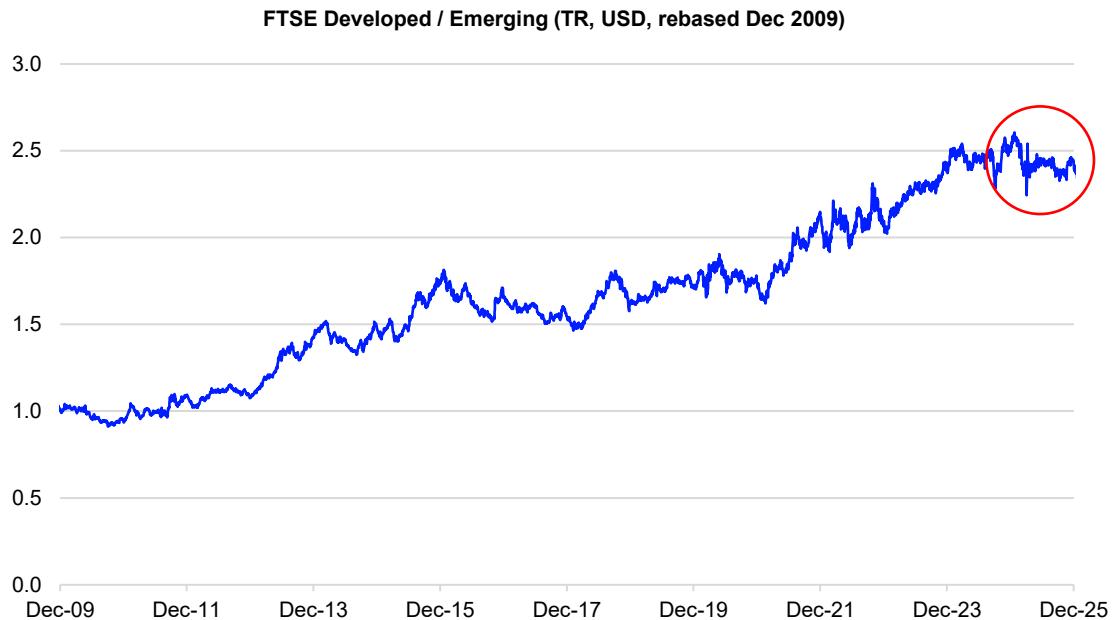
Source: FTSE Russell/LSEG. Data as of December 2025.

EMs' outperformance of DMs in 2025 was broad-based across equities, fixed income, and FX markets, as Exhibit 1 shows. EM equities outperformed DM equities by 3.7%, in US dollar terms, reflecting a multi-pillar contribution across industries (notable returns across Technology, Financials, Basic Materials, and Consumer Discretionary), as opposed to a narrow or concentrated source of returns such as the Technology dominance in the US. Region wise,¹ South Africa equities generated returns of 77.3%, primarily driven by Basic Materials (gold mining); Taiwan equities' returns of 40.7% were largely sourced from Technology; China equities gained 32.1%, staging a broad-based rally across industries including Technology, Consumer Discretionary, Financials, Basic Materials, and Health care.

It is worth noting that in the period after the Global Financial Crisis, DM equities have mostly outperformed EM equities, but 2025 has seen a reversal of that trend in favor of EMs (Exhibit 2). This was despite the geopolitical risks that were expected to have adverse impacts on economies with large exposures to global trade which included several major EMs.

¹ China, Taiwan, India, South Africa, Brazil, Saudi Arabia and Mexico were the top 7 countries by weight, in that order, in the FTSE Emerging index, accounting for 88% of index weight as of December 2025.

Exhibit 2: Developed equities have outperformed Emerging equities in most of the post-GFC period, however, in 2025 we saw the opposite dynamic.



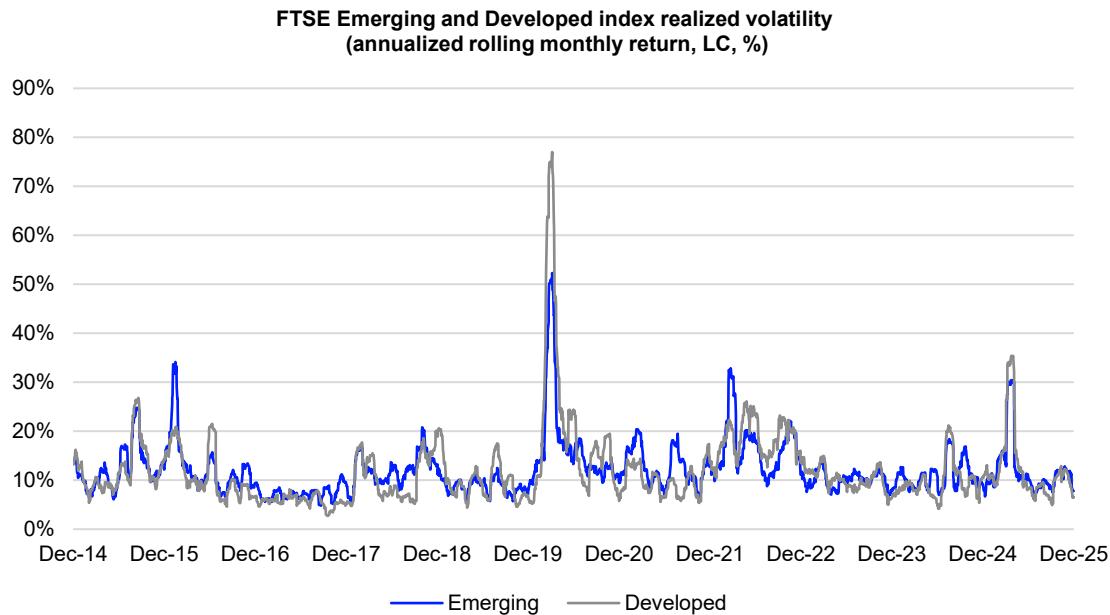
Source: FTSE Russell/LSEG. Data as of December 2025.

EM fixed income assets also performed well, as shown in Exhibit 1, with EM 7-10-year sovereign bonds modestly outperforming DMs, led by significant returns of 38-43% in US dollar terms in Brazil, Mexico, and South Africa, despite laggards in India and China.

FX returns proved another key component of EM asset returns for US dollar investors in 2025, given US dollar weakness for much of the year. The Mexican peso and Brazilian real were among the strongest -performing currencies within EMs in 2025, but they may face downside risk in the event of a yen carry trade unwind in 2026, given their roles as key EM counterparts in yen-funded carry trades.

One of the reasons for this positive re-rating of EM assets is investors' recognition of EM resilience. Exhibit 3 shows how EM equity volatility has been in line with that of DM volatility over much of the last 10 years. During brief periods, EM equity volatility was even lower than that of DMs. It is a reflection of the underlying strength of EM corporate balance sheets and profitability, and indicates a certain maturation of EM financial markets more generally.

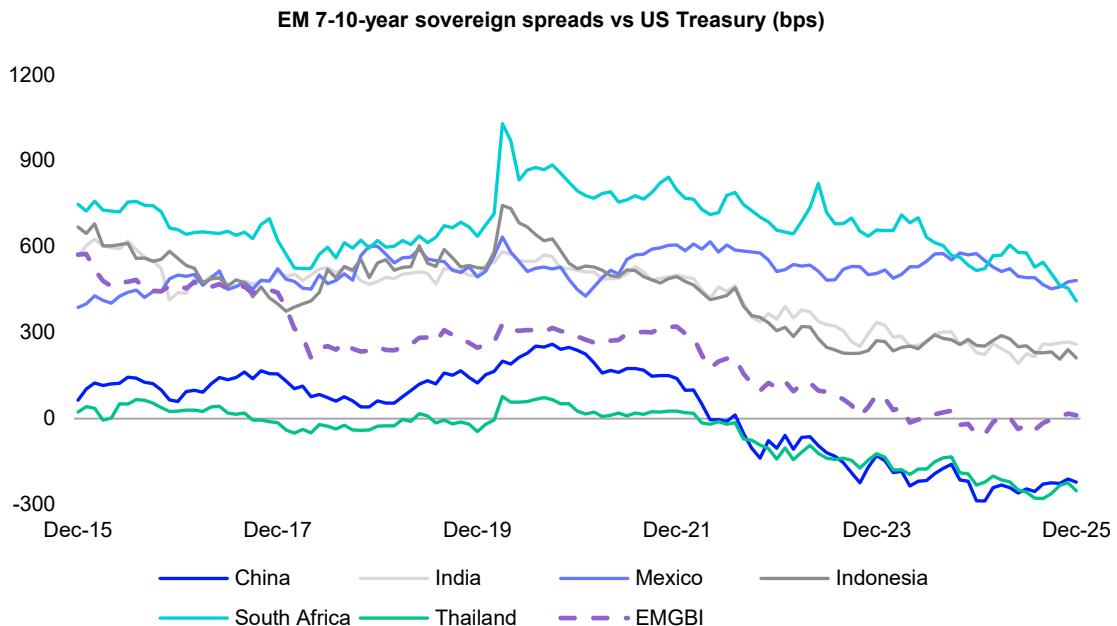
Exhibit 3: EM equity volatility has been in line with that of DM volatility over the last 10 years, indicating a certain maturation of the asset class.



Source: FTSE Russell/LSEG. Data as of December 2025. Realized volatility is annualized volatility of rolling 22-business day returns in local currency.

From a sovereign credit risk perspective, EM sovereign spreads versus Treasuries have tightened remarkably in the recent decade, as Exhibit 4 shows, led by China and high-yielding India and Indonesia. The compression of EM sovereign spreads reflects stronger macro fundamentals, enhanced policy credibility, and lower perceived sovereign credit risk within EMs. This momentum has strengthened in the recent four years, across both Fed tightening (March 2022 to July 2023) and easing (September 2024 onwards) cycles. South African sovereign spreads have seen a sharp fall in Q4 2025, largely helped by their sovereign credit rating upgrade by one notch to BB+, reflecting increases in investors' confidence due to improving growth and fiscal trajectory. India's 2025 sovereign rating upgrade is also expected to strengthen investor confidence, although it has yet to be fully reflected in sovereign bond performance.

Exhibit 4: EM sovereign spreads vs Treasuries have tightened meaningfully in the recent decade, implying lower EM sovereign credit risk relative to the US.



Source: FTSE Russell/LSEG. Data as of December 2025.

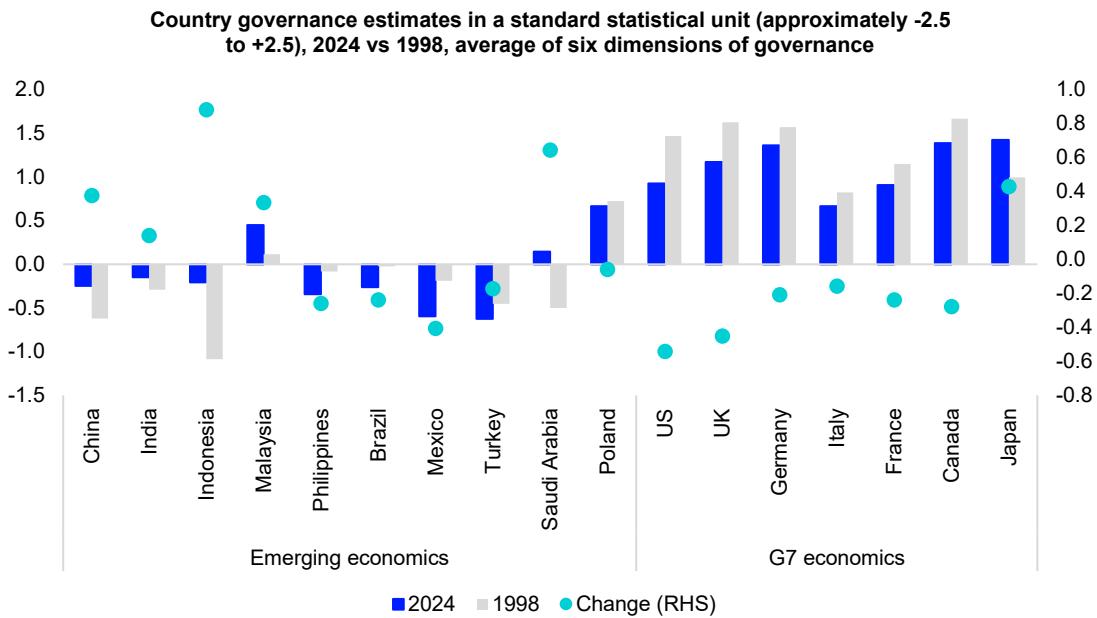
Question 2: Should EM outperformance versus DMs really come as a surprise?

Not entirely, as EMs have meaningfully reduced their macroeconomic and financial market vulnerabilities over time through improved country governance, enhancement of FX reserves and current account balances, and lower exposure to foreign currency denominated debt. EM vulnerabilities today are more likely to be idiosyncratic or localized, with a lower probability of contagion.

The World Bank measures country governance across 6 dimensions which are voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption. Exhibit 5 shows how many EM economies have seen country governance improvement since 1998, e.g. in China, India, Indonesia, Malaysia and Saudi Arabia. Indonesia, in particular, experienced meaningful development in all six dimensions of governance. Among these dimensions, government effectiveness has improved the most broadly across EMs; control of corruption was enhanced remarkably in Saudi Arabia and Indonesia, while it continued to be a challenge in Brazil and Mexico. In contrast to a bulk of EM economies showing structural progress in country governance, G7 governance quality has generally deteriorated since 1998 (except in Japan), with the political stability dimension being a major drag across the board (including for Japan, which sees improvement in the other 5 measures); control of corruption is another key contributor to the lower governance quality in the UK and Canada. Overall, stronger governance frameworks in EMs have reduced tail risks and volatility, helping to translate economic growth into more consistent financial asset outperformance. It is also noteworthy that the

effects of country governance improvements tend to be more gradual and indirect compared with the more immediate impact of reserve accumulation.

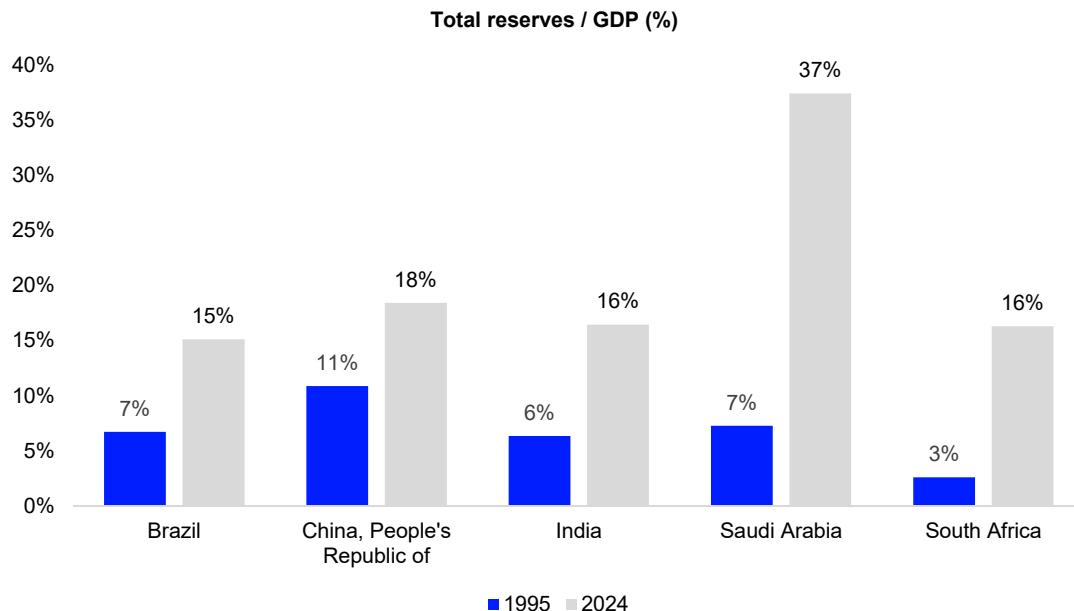
Exhibit 5: Governance improvement in many EMs vs broad deterioration in DMs.



Source: Worldwide Governance Indicators, 2025 Revision, World Bank (www.govindicators.org), Accessed on 12/15/2025.

Since the successive financial crises of the 1990s, often prompted by external vulnerabilities, EMs have made a concerted effort to accumulate foreign exchange reserves which provide them with a buffer to manage currency volatility and external shocks. Exhibit 6 shows how total reserves as a percent of GDP were notably higher in 2024 across key EMs when compared to the mid-90s. Improvement in EM current account balances further reduced their reliance on external financing. Both have strengthened EM macroeconomic resilience, thereby boosting investor confidence and performance in EM bonds and equities.

Exhibit 6: EMs have broadly strengthened their reserve position since the successive crises of the 1990s, boosting their ability to withstand external and domestic shocks.

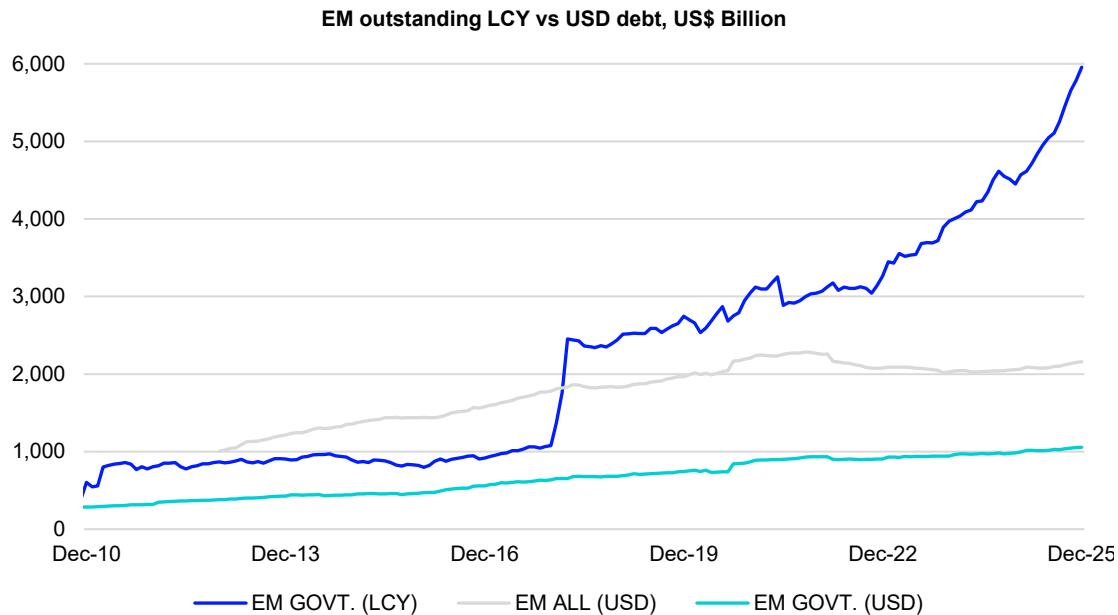


Source: FTSE Russell/LSEG and IMF. Data as of December 2024.

Building on improvements in country governance and reserves, another factor behind the reduced vulnerability of EMs is their lower exposure to foreign currency denominated debt. Emerging sovereign issuers as a whole have drastically reduced their reliance on hard dollar debt (which constitutes the largest share of bonds issued in foreign currencies) since the currency crises of the 1990s², as domestic bond markets deepened and, more recently, rising US dollar borrowing costs made USD-denominated issuance more expensive due to elevated yields on dollar bonds. This trend continued into 2025, as Exhibit 7 shows (India's inclusion into FTSE EMGBI since September 2025 partially explains the rapid growth since). A major benefit of this shift from external funding to domestic is that local currency (LCY) issuance helps minimize foreign exchange risk on debt servicing and improves resilience to external shocks, thus reducing vulnerability to the dollar strength over a longer time frame. Although some issuers also tap Euro and other markets to diversify funding sources beyond the dollar, LCY issuance share of the total is growing. On the demand side, LCY bonds became more attractive to foreign investors due to their attractive yields (particularly real yields) and favorable FX effects amid US dollar weakness.

² [A stronger US dollar – will EMs feel the pinch? | LSEG](#)

Exhibit 7: Emerging sovereign issuers have substantially reduced their reliance on hard dollar debt, shifting toward local-currency denominated bond financing.



Source: FTSE Russell/LSEG. Data as of December 2025.

Question 3: How should investors be thinking about the role of EM assets in a global multi-asset portfolio?

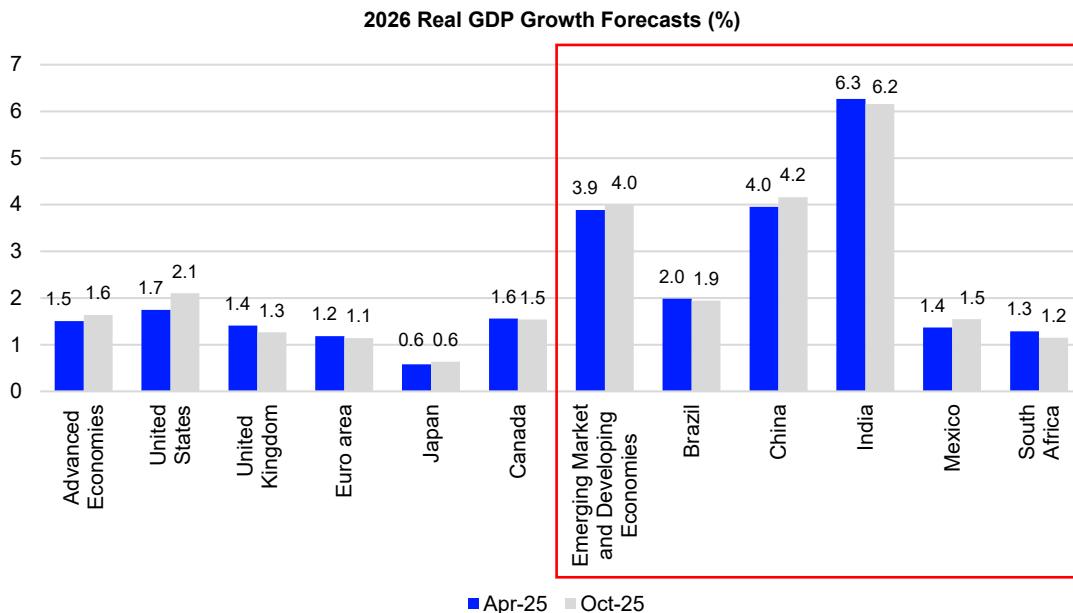
The gradual improvement in EM assets' risk profile has been many years in the making, beginning with fixed income and currency markets. Today, in a world of higher-than-usual economic uncertainty, risk-adjusted returns would be a top consideration for global investors. With their base of improved resilience, EM assets, in particular EM equities, could potentially offer compelling upside opportunities relative to DM equities, benefiting from several secular investment themes that have been driving equity markets recently.

Looking ahead, the macro environment remains constructive for EM equities. Exhibit 8 shows the evolution of forecast 2026 real GDP growth for select advanced and emerging economies. It is striking that the EM growth outlook has remained resilient through the US tariff turmoil and even improved in some cases,³ including in China. This is due to several factors. First, trade patterns that were disrupted by tariffs were reshaped rather than destroyed. In response to higher US tariffs, EM manufacturers found other markets for their goods. Second, EM growth drivers are manifold and not dependent on just one dimension such as exports. Many EMs such as India enjoy favorable demographics with rising spending power and consumption-driven growth. This is not to dismiss the

³ Although not back to levels prior to 2025.

importance of exports for EMs and of large markets like the US, but developing markets and consumers themselves play an increasing role in sustaining EM growth. Further, EMs' projected growth is higher than that of key DMs.

Exhibit 8: EM growth outlook has remained resilient through the tariff turmoil of 2025. There is variation within EMs, with several economies sustaining growth at higher levels despite maturing.

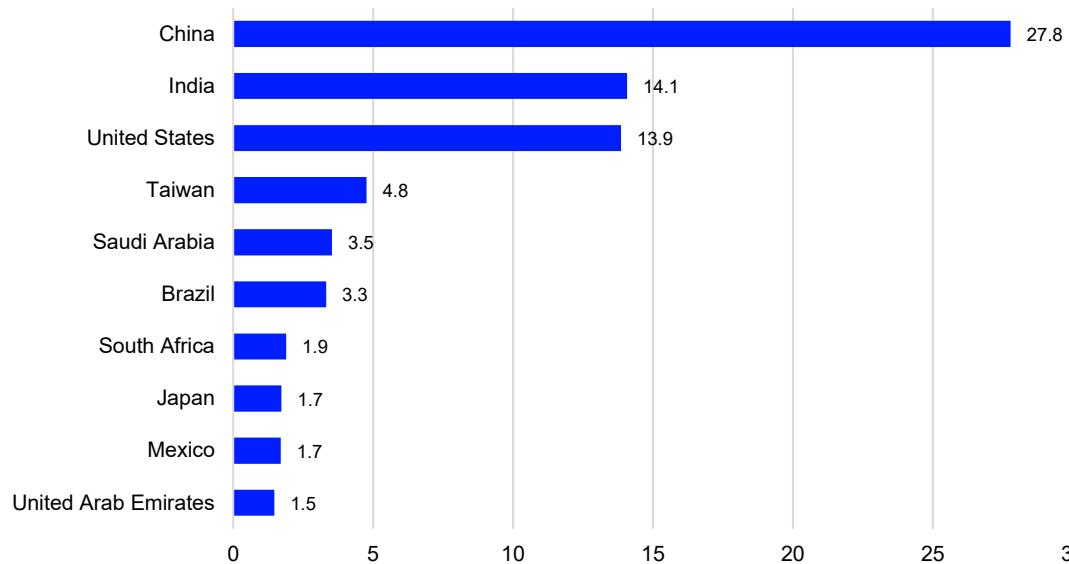


Source: FTSE Russell/LSEG and IMF World Economic Outlook October 2025.

An analysis of where EM corporates draw their revenue from provides an indication of their dependence on other EMs and developing economies. Exhibit 9 shows the top 10 country revenue sources for the companies within the FTSE Emerging index. The top 10 countries account for nearly 75% of total revenue of index constituents, calculated considering constituents' index weight. Not surprisingly, China is an important revenue source or market for EM corporates, given a third of the index weight is in Chinese equities and given the size of its consumer base. But beyond that, the US and Japan are the only DMs to feature in the top 10 country revenue sources for the Emerging index, together accounting for 15.6% of the revenues of index constituents.

Exhibit 9: EMs are not so dependent on the Western consumer as before; developing markets themselves largely sustain EM corporates.

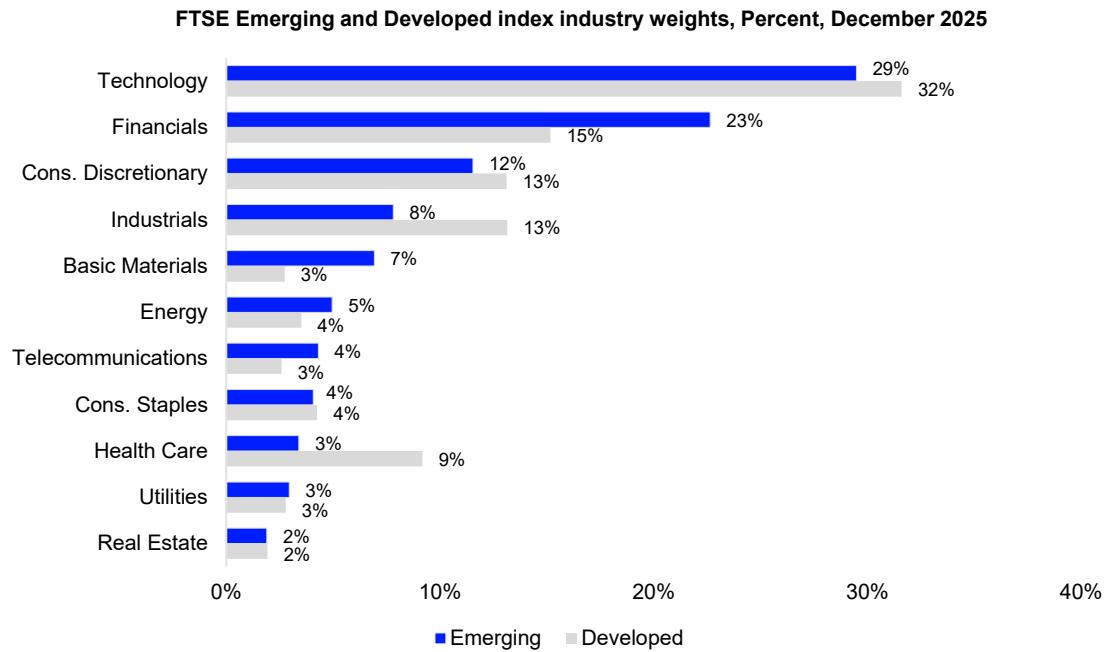
FTSE Emerging index top 10 country revenue sources, Percent, December 2025



Source: FTSE Russell/LSEG and FactSet. Data as of December 2025.

Investors should also consider that EM corporates are diversified by industry and sector, not unlike in DMs, but with some key differences. Exhibit 10 shows the FTSE Emerging and FTSE Developed index industry weights. Technology, Financials and Discretionary are the largest industries in both indices. The biggest differences between the two indices are in Financials and Basic Materials where the Emerging index has an overweight, and in Industrials and Health Care where the Emerging index has an underweight. Some of these differences become important when considering structural tailwinds to EM equities.

Exhibit 10: EMs offer broad industry exposure to investors, similar to the Developed index but with key differences.



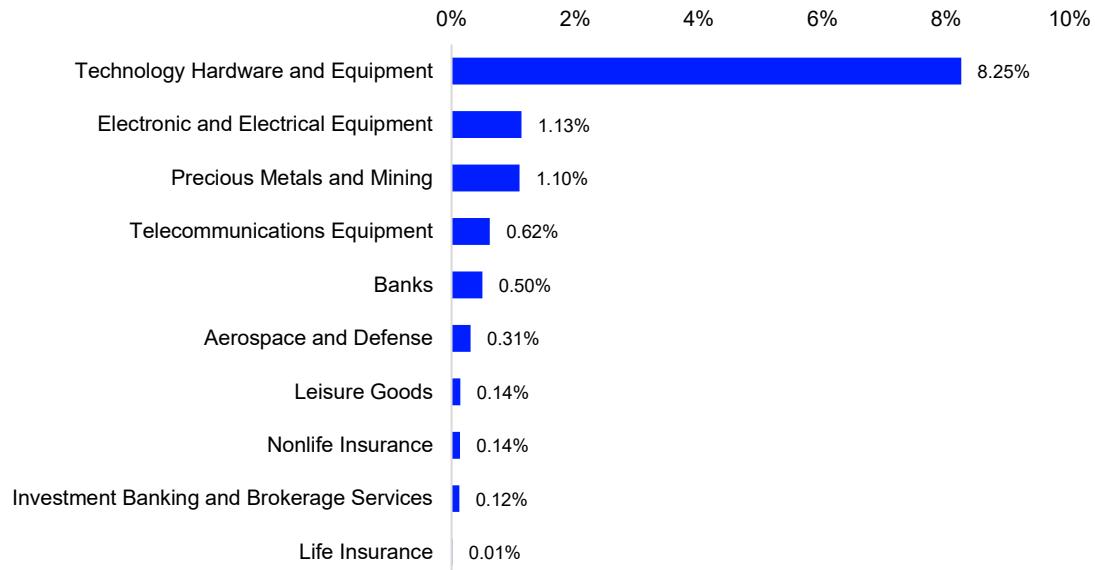
Source: FTSE Russell/LSEG. Data as of December 2025.

The changes in EM sector weights that led to the current index composition help us understand those tailwinds. Exhibit 11 shows the FTSE Emerging sectors⁴ that have increased in weight the most over the last three years (approximately since the release of Chat GPT in November 2022). Unsurprisingly, Tech Hardware has seen the largest rise in weights, riding on the AI investment juggernaut. Second-order beneficiaries of the AI theme, within Electronic and Electrical Equipment and Telecoms Equipment, necessary for the AI hardware build-out, also recorded meaningful increases in index weight.

⁴ One level more granular than at the ICB industry level. The 11 ICB industries are further categorized into 42 sectors <https://www.lseg.com/en/ftse-russell/industry-classification-benchmark-icb>.

Exhibit 11: The EM index's composition today is underpinned by trends such as AI investment and emerging technologies, rising spending power, and the green transition that have driven EM equity returns over the last three years.

FTSE Emerging sectors with the largest increase in weights over 2022-2025



Source: FTSE Russell/LSEG. Data as of December 2025.

Another notable sector weight change in Precious Metals and Mining reflects the extraordinary recent demand for metals such as gold and silver. The AI build-out, green transition and diversification away from the mighty dollar have fueled demand for specific industrial and precious metals. While gold has benefited both from its safe haven, inflation hedge and dollar diversifier roles in the post-Covid world, silver has soared on the back of both industrial and investment needs. The green transition has generated demand for metals such as silver and copper that supply has yet to catch up with given the long lead times for onboarding new supply. Emerging equities related to the mining and refining of these metals have reaped the rewards. And this area is a key difference in the composition of the Emerging and Developed indices.

Increased weights in Banks reflects the impact of steepening yield curves more recently, which has supported banks' net interest margins and profitability. Composition changes in other sectors such as Insurance and Leisure Goods reflect the rise in spending power and demand for these products from the EM consumer.

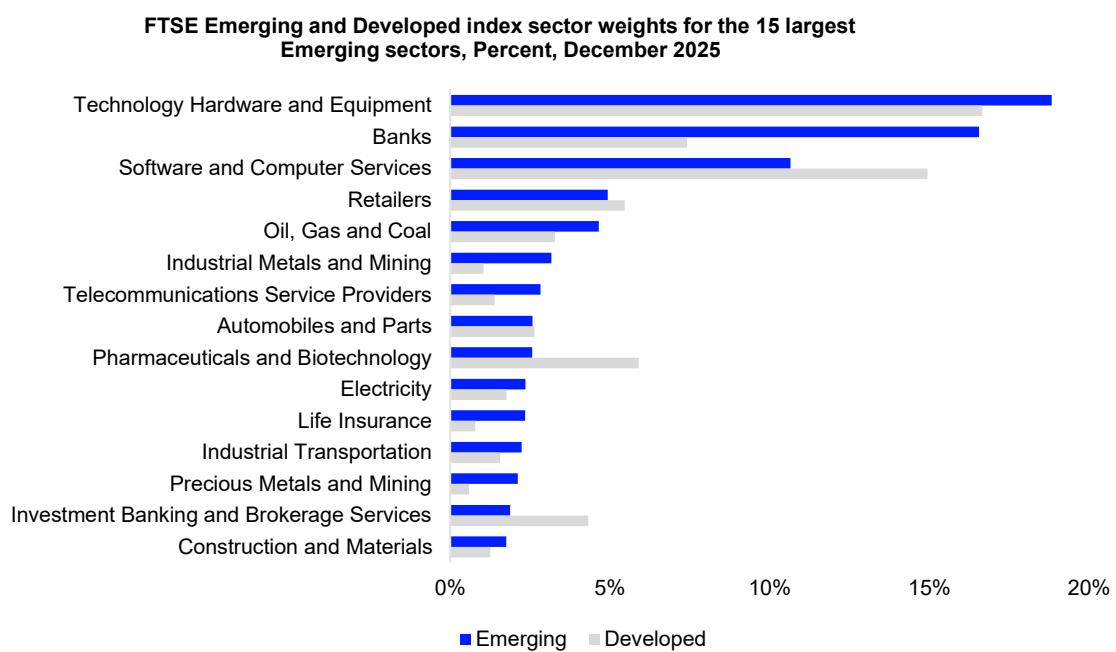
These structural tailwinds that have driven markets over the last three years likely have room to run and EMs are positioned well to benefit from them, all else equal. Exhibit 12 shows the current FTSE Emerging sector weights for the 15 largest sectors (along with their corresponding weights in the FTSE Developed index), many of which are related to these themes.

The AI theme, despite wobbles in late-2025 related to valuations and expected payoffs, is likely to continue to be a key driver of markets over the short-term if planned capex in this space is any indicator. Importantly, investors are looking for diversified sources of return related to the AI theme, given stretched valuations in Big Tech and US equities generally. EM equities may stand to benefit from this more than DM ones from a valuation

standpoint (as discussed in the next section on cyclical drivers), from the perspective of the broadening AI build-out (e.g. building data centers in EMs with smaller investment; developing cheaper AI models such as DeepSeek), and in the pace of adoption of AI and other emerging technologies seen in EMs versus DMs (e.g. the degree of automation in Chinese factories). In this sense, EM equities may offer investors a broader array of choices for investing in this theme.

The green transition and electrification themes are still underway, and as the EM consumer's spending power rises on the back of EM growth, sectors within Consumer Discretionary, Financials and Health Care are likely to continue to experience secular tailwinds.

Exhibit 12: EM equities are positioned to continue to benefit from the investment themes that have been driving markets over the last several years.



Source: FTSE Russell/LSEG. Data as of December 2025.

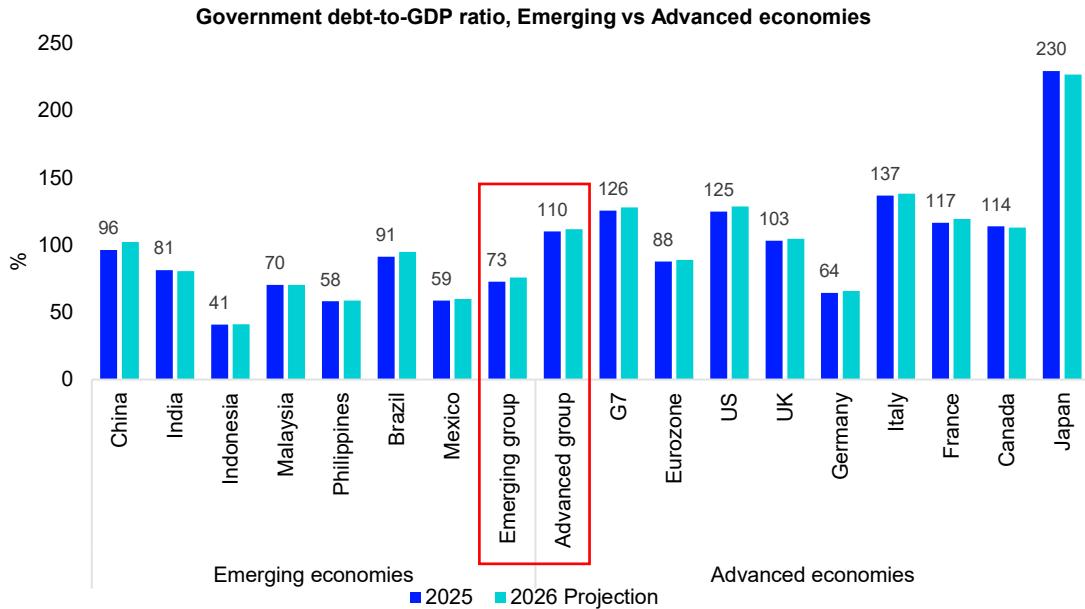
It is worth noting that within EMs there is considerable variation in industry/sector exposures. Asian equities have generally benefitted more from the AI theme and other emerging technologies (e.g. demand for solar panels, electric vehicles), while Latin American and South African equities have higher exposure to the precious and industrial metals supply chains.

Question 4: Beyond the structural tailwinds just discussed, what cyclical advantages have driven – and may continue to support – EMs' strong financial market performance?

From a broad economic perspective, EM economies benefit from a weaker US dollar (a key theme in FX markets in 2025), which reduces external debt-servicing costs, supporting fiscal positions. From a policy standpoint, EMs enjoy more fiscal space than DMs, while their monetary policy independence from DMs buffers them to an extent from domestic and global shocks. In the context of equity markets, EM equities are supported by solid fundamentals, including robust earnings growth forecasts, relatively attractive valuations, and lower correlations with DM equities. Taken together, these factors (some could be a mix of cyclical and structural factors) suggest a favorable environment for EMs in the current cycle.

Exhibits 13 and 14 illustrate how fiscal and monetary policy approaches have differed between EMs and DMs. While many advanced economies have accumulated substantial public debt after years of expansionary policies – driven by repeated economic shocks, persistent fiscal deficits, and demographic pressures, several EMs have withstood recent global challenges with lighter debt burdens and more disciplined fiscal frameworks, as reflected in the lower public debt-to-GDP ratio in EMs (~73%) versus DMs (~110%). This provides them with greater flexibility to implement countercyclical fiscal policies without immediately jeopardizing debt sustainability.

Exhibit 13: EMs' lower debt-to-GDP ratio implies that EM governments have more fiscal space for counter-cyclical policy than highly leveraged DMs.



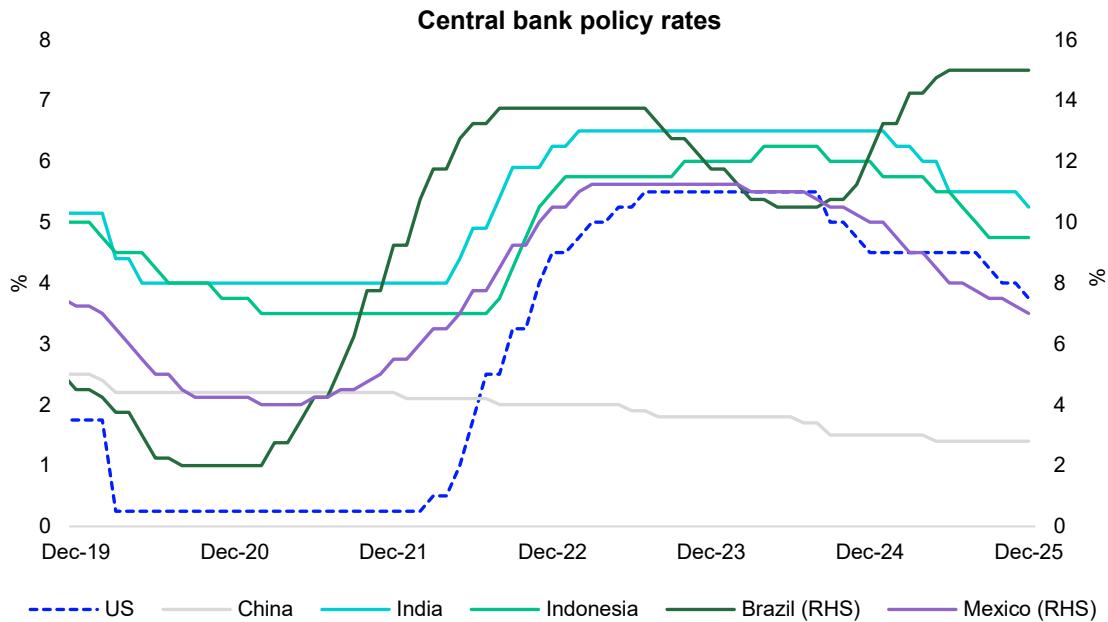
Source: IMF, World Economic Outlook, October 2025.

On the monetary policy front, EMs have demonstrated greater independence, rather than simply following DM policies. China, for example, has consistently maintained an accommodative monetary stance post-Covid to support economic growth amid deflationary pressures. This stands in stark contrast to most major economies, which tightened monetary policy in 2022-23 to contain high inflation. Meanwhile, central banks in Brazil and Mexico moved earlier and more decisively than their DM peers during the recent global hiking cycle. They initiated their first interest rate hikes as early as H1 2021 (Brazil in March, and Mexico in June) to curb rising inflation, about a year ahead of the Fed hikes starting from March 2022⁵, as Exhibit 14 shows.

This combination of stronger fiscal sustainability and credible monetary policy enhances EMs' capacity to respond to economic shocks, supporting resilient macroeconomic outcomes over the medium term.

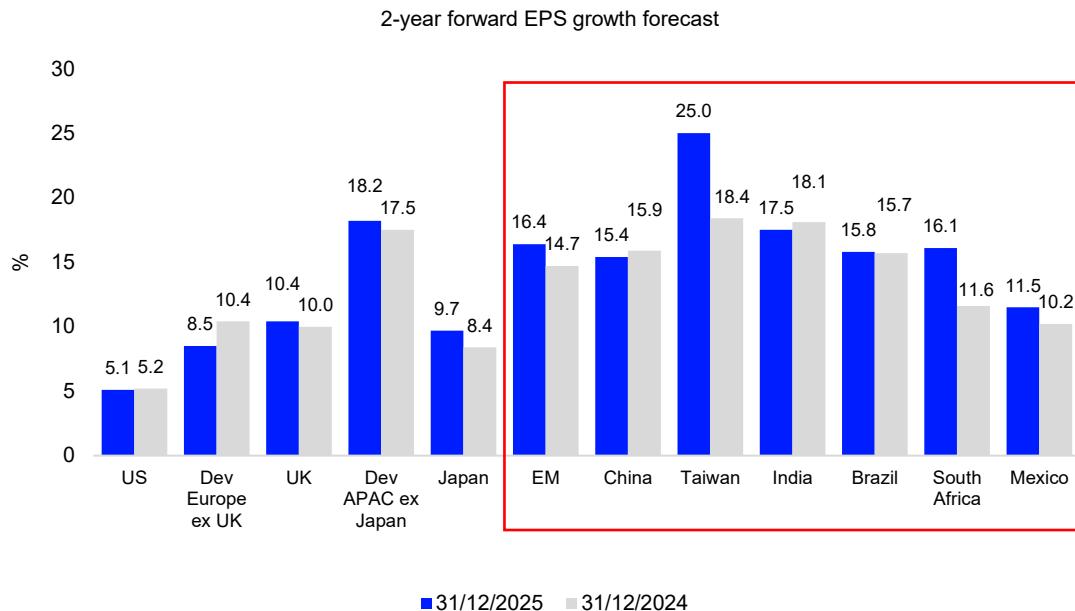
⁵ [Why did the Brazilian Real and Mexican Peso outperform USD? | LSEG](#)

Exhibit 14: EM central banks have adjusted policy rates in line with their domestic macroeconomic fundamentals rather than purely tracking DM monetary cycles, underscoring the independence and credibility of EM monetary policy frameworks.



With stronger policy frameworks in place, EM equity markets have shown supportive fundamentals, including robust earnings growth forecast, relatively low valuations, and lower correlations with DM equities. Exhibit 15 shows how the EM 2-year forward EPS growth forecasts as of end-2025 stand higher than major DMs of Japan, Europe, and the US (EM growth at 16%, more than 3x that of the US ~5%), implying potentially higher corporate profitability and better equity returns. In particular, Taiwan and South Africa rank among the top and have seen significant upward revisions by end-2025 vs end-2024.

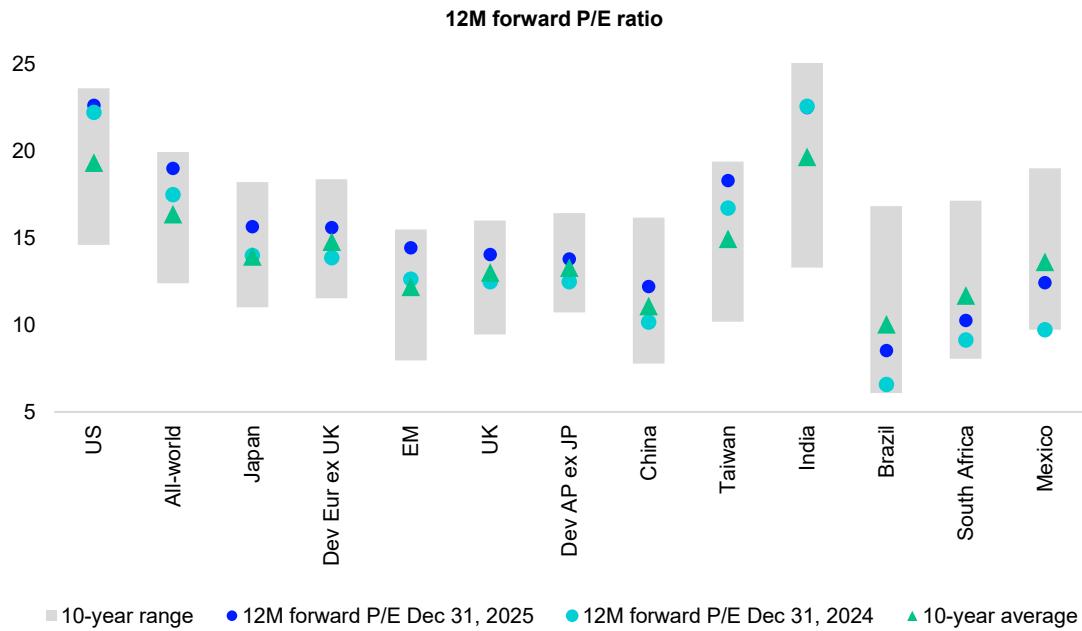
Exhibit 15: Higher earnings growth forecasts in EMs could provide a stronger tailwind for EM equity returns relative to DMs.



Source: FTSE Russell/LSEG. Data as of December 2025.

EM equity valuations stayed relatively subdued compared with DM equities, despite a re-rating in 2025 vs 2024, as shown in Exhibit 16. 12M forward price-to-earnings ratios for Brazil, Mexico and South Africa remained below historical averages, dampening overall EM valuations. Chinese equities traded notably below Asian peers such as India and Taiwan at the end of 2025, despite their large upward re-rating during the year. This valuation gap between EMs and DMs continues to increase the appeal of EM equities for investors seeking higher return opportunities.

Exhibit 16: EM equity valuations remain relatively attractive compared with DMs despite their 2025 re-rating, particularly in LATAM and South Africa.

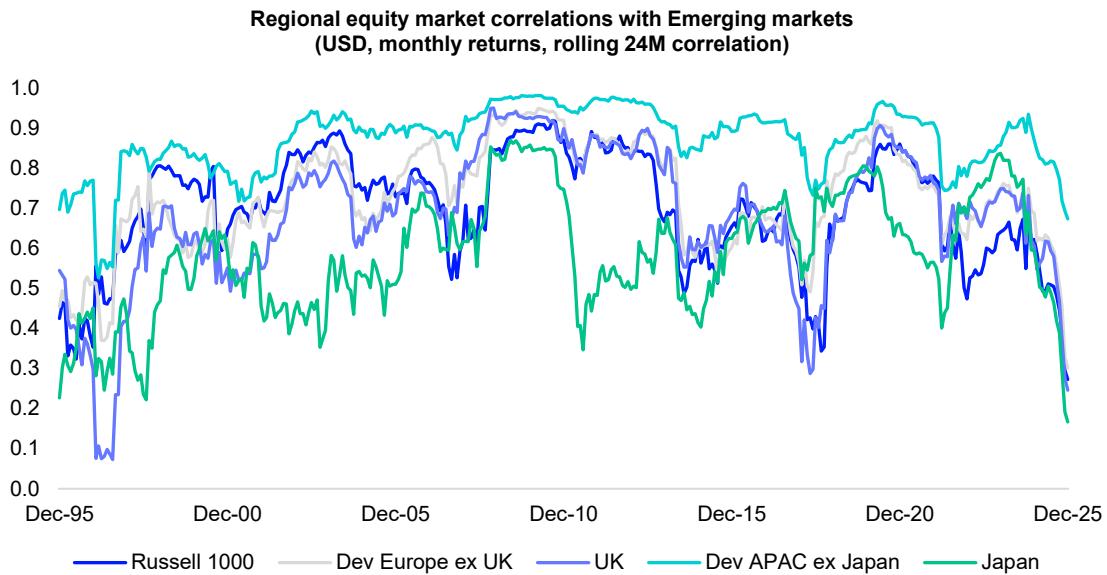


Source: FTSE Russell/LSEG. Data as of December 2025.

Diversification benefits are a key consideration in portfolio management and asset allocation, in addition to seeking higher returns, and this is exactly what EM equities have offered to investors in 2025 during the most recent easing cycle. Exhibit 17 shows that EM equities' correlations with major DM equities have dropped sharply to levels near 30-year lows, a deeper dive than post-Covid. The combination of competitive returns and lower correlations in EM equities has led to renewed investor interest amid the risk-on sentiment, and the shift is evident in equity fund flow data – improving inflows into EM equity strategies (and larger inflows to Europe) have coincided with significant outflows from US equity funds⁶.

⁶ [Global Wealth Research - January 2026 | LSEG](#)

Exhibit 17: With correlations between EM and DM equities at cyclical lows, global equity investors may gain meaningful diversification benefits from EM exposure.



Source: FTSE Russell/LSEG. Data as of December 2025.

Question 5: What are the investment implications for global investors?

The case for a higher allocation to EM assets in global portfolios has strengthened.

EM assets' risk-return profile has changed drastically in the decades since the Asian Financial Crisis, with fixed income and currency markets showing vastly improved resilience. EM equities now offer the potential for higher risk-adjusted returns relative to DMs, drawing on both structural and cyclical tailwinds while offering diversification benefits. One point of reference for EM equity allocation is EM equity market capitalization relative to global equities. This stood at 10.2% at the end of 2025, after having peaked at around 13.2% in late-2010, post the Global Financial Crisis. Emerging markets and developing economies are also estimated by the IMF to have accounted for 41% of global GDP in 2025, and their share is projected to increase to 44% by 2030 underpinning financial market performance with economic growth.

EMs may lend themselves to more selective, granular exposures.

EMs are not a monolith. Just as EM vulnerabilities today are more likely to be idiosyncratic, with a lower probability of contagion, opportunities within EMs are varied with distinct macro and market drivers. At a macro level, some countries have better established policy frameworks and faster growth outlooks than others. Certain regional EM equities have higher reliance on a specific investment theme, such as AI, while others have multiple drivers. Investors looking to complement their DM exposures with specific investment themes and/or maximize risk-adjusted returns with more growth-oriented sectors, could potentially find those opportunities within the EM equity universe.

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