1Q 2025

Investment Highlights

Western Asset
A Franklin Templeton Company

Western Asset Emerging Markets Debt Sector

This is a marketing communication.

Key Takeaways

- *At Western Asset, we anticipate some volatility in 2025, but believe tariff uncertainty will create attractive opportunities in the EM space.*
- *In frontier markets, we continue to hold select exposures and see value in certain new issuances.*
- *EM corporates remain a core holding as they continue to benefit from conservative financial policies and strong duration-adjusted carry.*
- *In the realm of EM local markets, we are adopting a more cautious approach due to uncertainty surrounding Trump tariffs.*

Market Review

Proposed trade and foreign policy changes from the new US administration created uncertainty and volatility in financial markets in the first quarter of 2025 with divergence in fixed-income returns—strong returns from US government bonds and many emerging market (EM) government bonds, and negative returns from Japanese and eurozone government bonds. Spread sectors provided positive returns but generally underperformed government bonds. The unpredictability of the proposed policy changes drove a sharp correction in US stocks, and the US dollar weakened.

US economic data, such as retail sales, durable goods orders and the unemployment rate continued to indicate a resilient economy. However, uncertainty surrounding tariffs and other policy changes negatively affected business and consumer sentiment. US Treasuries (USTs) rallied as slower growth prospects increased the likelihood of Federal Reserve (Fed) rate cuts, while the yield curve steepened due to tariff-related inflation and US fiscal policy concerns. Following the German election, Chancellor Friedrich Merz announced a major fiscal plan featuring a €500 billion infrastructure fund and relaxed fiscal rules for defense spending. Significant EU-wide defense spending proposals were also announced. The expected boost to confidence and growth pushed eurozone government bond yields higher. The European Central Bank (ECB) lowered rates by 25 basis points (bps) in January and March, and the Bank of England (BoE) cut rates by 25 bps in February. The UK Chancellor's Spring Statement and updated Office for Budget Responsibility forecasts were in line with expectations. Inflation unexpectedly slowed, but markets remained cautious about future BoE rate cuts as inflation is expected to rise again in the coming months. The Bank of Japan hiked rates by 25 bps in January to 0.5% and Japanese government bond yields rose due to strong growth and inflationary pressures, leading to expectations of further rate hikes. Local EM government bonds generally posted strong positive returns. Mexican bonds benefited from weaker-than-expected growth and lower inflation, allowing the central bank to cut rates by 50 bps in both February and March. Brazilian bond yields declined as currency strength suggested a lower terminal policy rate and rate cuts earlier than previously expected. Indian bonds rallied on anticipated foreign inflows due to a shift towards monetary easing. South African bond yields rose modestly amid stalled budget talks.

The EM sector generated largely positive returns in the first quarter. The JPMorgan Emerging Markets Bond Index Global Diversified returned 2.24%. Local markets, as measured by the JPMorgan Government Bond Index-Emerging Markets Global Diversified in USD, posted a return of 4.31%.

Frontier markets, representing a subset of smaller EM countries as measured by the JPMorgan NEXGEM, returned 2.02%.

Investment Outlook

Global growth is expected to slow given the heightened uncertainty but should remain solidly in positive territory. US growth is downshifting due to a myriad of factors: uncertainty over tariffs, waning benefits from immigration and reduced government spending, among others. A significant fiscal boost from European defense and Germany infrastructure spending should support eurozone confidence and growth, providing some relief from tariff-related uncertainty. In China, deflationary pressures remain and confidence is weak amid property market concerns, but sentiment is improving with fiscal stimulus and policy easing.

The disinflationary trend may be interrupted as tariffs and retaliatory actions are implemented, but we expect inflation to move lower again over the longer term. Monetary policy remains restrictive. We expect central banks will continue to cut rates modestly in 2025. The Fed remains well positioned to provide support if the US economy falters. Public debt levels continue to rise and yield curves may steepen given concerns over fiscal policies globally. We see pockets of opportunity in DM rates in Europe, the UK and Australia. While the overall uncertainty in the market environment necessitates caution, we do see some longer-term value opportunities in EM local currency debt. Spread sector fundamentals remain supportive, but valuations reflect those fundamentals and credit spreads persist at below historical averages. We continue to find opportunities within spread sectors and related securities while remaining tactical. DM duration provides useful diversification.

Within EM, credit has shown resilience into 2025, posting positive total returns year-to-date and marginally tighter spreads. Fundamental performance has been relatively stable, which is reflected in current spreads. The US Fed is expected to resume cuts following a pause in the easing cycle and we expect EM central banks to follow suit, allowing local sovereign yields to fall over the medium term. We anticipate some volatility in 2025 but believe that tariff uncertainty will create attractive opportunities in the EM space. In frontier markets, we continue to hold select exposures and see value in certain new issuances. EM corporates remain a core holding, as they benefit from conservative financial policies and strong duration-adjusted carry. In the realm of EM local markets, we are adopting a more cautious approach due to uncertainty surrounding Trump tariffs.

Risk Disclosures

All investments involve risks, including possible loss of principal. Fixed-income securities involve interest rate, credit, inflation, and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed-income securities falls. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. Asset-backed, mortgage-backed or mortgage-related securities are subject to prepayment and extension risks. High yield bonds are subject to greater price volatility, liquidity, and possibility of default.

The **Consumer Price Index (CPI)** tracks prices for a basket of more than 80,000 goods and services.

The **Federal Reserve Board (Fed)** is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

The **Fed Funds Rate** is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight.

Gross domestic product (GDP) is an economic statistic that measures the market value of all final goods and services produced within a country in a given period of time.

The **JPMorgan Emerging Markets Bond Index Global ("EMBI Global")** tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, Eurobonds.

The **JPMorgan Emerging Markets Bond Index Global Diversified Index (EMBI® Global Diversified)** is a uniquely-weighted version of the EMBI Global. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding. The countries covered in the EMBI Global Diversified are identical to those covered by the EMBI Global.

The **S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S.

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