Investment Highlights

# Western Asset Emerging Markets Debt Sector

WESTERN ASSET
A Franklin Templeton Company

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## Key Takeaways

- At Western Asset, we anticipate some volatility in 1Q26, but believe any market repricing 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.
- For EM local markets, we still see room for selective tightening and continue to view the segment as a useful portfolio diversifier.

## Market Review

Fixed-income market volatility continued in the fourth quarter of 2025 as investors and policymakers digested the mixed data signals. The longest US government shutdown, which limited the data availability, came to an end in November after 43 days. Short and intermediate US Treasury (UST) yields ended the quarter lower, whereas long-term yields rose. UK gilt yields declined across the curve. Core European and Japanese yields generally rose.

The Federal Open Market Committee (FOMC) cut the Federal Reserve (Fed) policy rate twice, by 25 basis points (bps) to a target range of 3.50% to 3.75%. In December, the committee added language to its statement linking “the extent and timing” of further policy actions to incoming data and the evolving outlook. The Fed also resumed reserve purchases to provide for ample liquidity and smoother policy transmission. US 3Q GDP rose 4.3% (annualized) on strong consumer spending and investment. The unemployment rate reached 4.56%, while inflation moderated with headline Consumer Price Index (CPI) at 2.7% and core CPI at 2.6%.

The European Central Bank (ECB) held policy rates unchanged. However, following hawkish comments from ECB member Isabel Schnabel that highlighted potential upside surprises to eurozone growth, markets moved to expect higher rates in 2026. S&P downgraded France’s sovereign credit rating from AA- to A+ citing slower than expected budgetary consolidation and deteriorating debt metrics.

UK gilts outperformed as the Bank of England cut rates 25 bps to 3.75% and UK economic data was weaker than expected. Real GDP in the UK contracted 0.1% from August to October. Retail sales fell 1.1% month-over-month (MoM) in October and by 0.1% MoM in November. UK core CPI declined from 3.4% in October to 3.2% in November.

The Bank of Japan (BoJ) raised its policy rate by 25 bps to 0.75%, but forecasted sluggish inflation and modest growth, while the yen weakened on expectations of slower rate hikes. Sanae Takaichi became Japan’s Prime Minister, launching a bold fiscal stimulus of ¥21.3 trillion and abandoning the single-year primary budget surplus target, which pushed Japanese government bond yields higher.

Many emerging market (EM) central banks continued to cut policy rates. Local currency EM government bonds posted strong positive returns. In China, the yield curve steepened with shorter-dated government yields falling.

Spread sectors outperformed. However, significant long-dated issuance for AI infrastructure investment saw the US investment-grade corporate media and technology subsectors underperform.

## Outlook

Western Asset's outlook remains constructive, though we recognize that growth momentum is tempered by uncertainty in areas such as geopolitics and fiscal sustainability.

US financial conditions are largely supportive, which, alongside proposed fiscal loosening and solid household balance sheets, points toward a positive foundation for growth in 2026. Headwinds remain, including doubts over the state of the US labor market, core inflation lingering above target and the potential lagged impact of tariffs. Having cut rates at three successive meetings since September, the Fed may now moderate its pace of easing and await further signals from the post-shutdown data releases. Fiscal vulnerabilities and persistent inflation may see the yield curve steepen further.

European growth is expected to benefit from German and EU fiscal support with the ECB judging the eurozone economy to be "in a good place" with growth remaining positive and inflation close to 2%. In Japan, above-trend growth is expected in 2026 with a more expansionary fiscal policy under the new prime minister. The gradual pace of BoJ policy rate hikes is expected to continue. In China, policy is expected to focus on reflation and improving domestic confidence with further fiscal and regulatory support.

While we retain a modest overweight to interest-rate duration, we are concentrated in shorter maturities and biased to select countries and regions such as core Europe, Australia and the UK. While fundamentals remain positive, spreads are at the tight end of historical ranges in many sectors and warrant caution. We will continue to look for further periods of volatility to add to spread risk.

We viewed 2025 as the beginning of a favorable multi-year window for EM outperformance, driven by attractive valuations and a supportive macro environment. One year later, we believe our thesis that EM is "coiled for a comeback" remains intact. Growth across many EM economies continues to outpace developed markets, disinflation has progressed without destabilizing activity and real policy rates remain elevated as central banks have maintained relatively restrictive monetary settings despite recent cuts. Frontier markets that initially came under stress in 2024 have largely remained market accessible and extended maturity profiles, while IMF program engagement has continued. Reform momentum through 2025 has supported ongoing disbursements and improved investor confidence. Overall, we anticipate another period of market volatility in the first quarter of 2026 due to ongoing tariff uncertainty, political headline risk and geopolitical tensions. However, any market repricing should create attractive investment opportunities across the EM universe.

## 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.

Inflation is the rate of increase in prices over a given period of time. Disinflation is a slowdown in the rate of price inflation, not a decrease in overall prices.

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