

Emerging markets: Inflation, central banks, and near-term debt outlook



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A smaller shock, stronger policy buffers, and a carry-led opportunity

- **A limited inflation shock:** Notwithstanding broad price pressures, the energy shock has been smaller than in 2021–2022. Our base case remains a temporary increase in headline inflation, with persistent pressure more likely where currencies, wages, or fiscal policy amplify the shock.
- **Policy and regional divergence key to outcomes:** Stronger credibility and higher real rates should allow many EM central banks to pause or slow rate cuts—widespread tightening seems unlikely. The most resilient markets should be those where inflation expectations remain stable, foreign exchange reserves are adequate, and fiscal policy is disciplined.
- **Favor carry, quality, and selectivity:** High starting yields should support income across EM debt. In local currency, markets with credible policy frameworks and limited external vulnerability present opportunity. In hard currency debt, tight spreads highlight the importance of duration management and country selection.

Since we set out our “[Enduring Strength](#)” thesis in January—and reaffirmed it in [June](#)—many emerging market (EM) economies have continued to demonstrate better-anchored inflation, more credible policy frameworks, and healthier fiscal positions than much of the developed world. That view has strengthened through 2026. Developed market government bond markets have faced growing concerns that the fiscal-driven risk we flagged is materializing—while EM fundamentals have broadly continued to better their developed counterparts. We retain a cautiously optimistic view even as performance has not been uniform across local and hard currency debt, and the geopolitical landscape has been shaken by developments in the Middle East.

The key question is whether renewed energy pressure will reverse the disinflation trend and trigger a repeat of the aggressive tightening and market losses seen in 2021–2022. We do not anticipate this scenario unfolding. The current inflation impulse is much narrower: although oil prices are elevated, they remain below the 2022 high; the energy supply disruption is not accompanied by post-lockdown excess demand; and many EM central banks begin with positive real rates and stronger credibility. Headline inflation may rise temporarily, but a broad return to persistent inflation is not our base case. Many central banks are therefore more likely to look through first-round energy effects rather than leap hastily to rate-hike mode.

For investors, high starting yields for EMD should support carry and provide some cushion against potential losses. Opportunities thus exist in the local currency EM bond space, although selectivity is key because currency movements—shaped by US policy and each country’s financial situation—could impact returns.

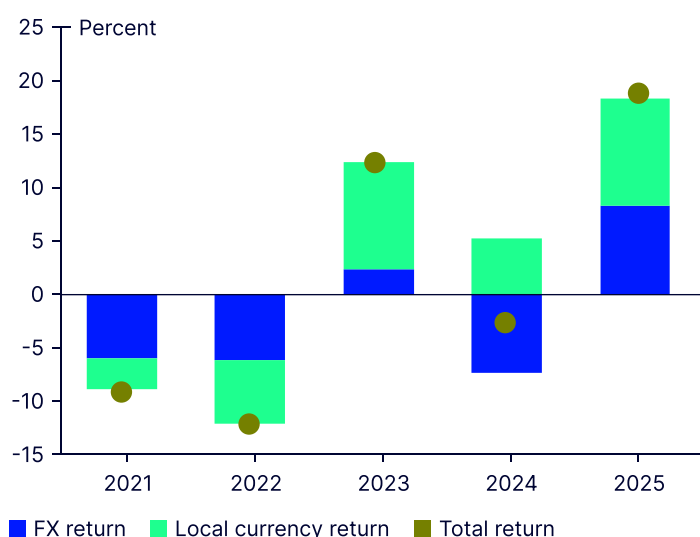
Inflation Scenario	Likely central bank response	Near-term EMD impact
Contained energy shock; core inflation continues to ease	Slower, selective cuts	Carry-led positive returns; selective duration gains
Sticky headline inflation: expectations remain anchored	Extended pauses	Range-bound rates; income offsets volatility
Broad second-round inflation and FX pressure	Targeted re-tightening	Local bonds and currencies weaken; hard currency spreads widen

Why this inflation episode is different

The 2021–2022 inflation surge reflected several forces: the release of pent-up demand after lockdowns, severe goods and logistics bottlenecks, exceptional fiscal support, and the food and energy shock that followed Russia’s invasion of Ukraine.

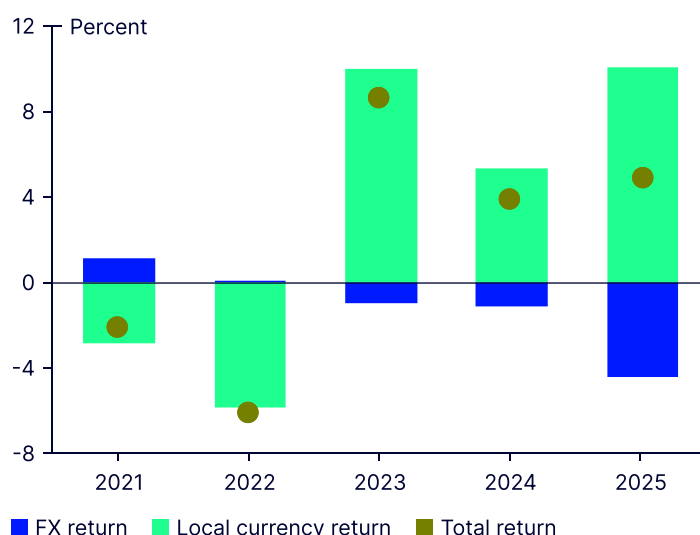
This was a difficult period for EMD investors. EM central banks tightened into a Federal Reserve hiking cycle, while a stronger dollar magnified losses for USD-based investors, as evident in Figure 1. Russia’s removal from major sovereign indices at a zero price also accounted for a considerable portion of hard and local currency benchmark losses.

Figure 1a: EM debt returns, base currency USD (2021–2025)



Source: State Street Investment Management, JP Morgan as of September 30, 2026. Returns are for the JP Morgan GBI-EM Global Diversified Index in USD terms. The performance data quoted represents past performance. Past performance does not guarantee future results. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

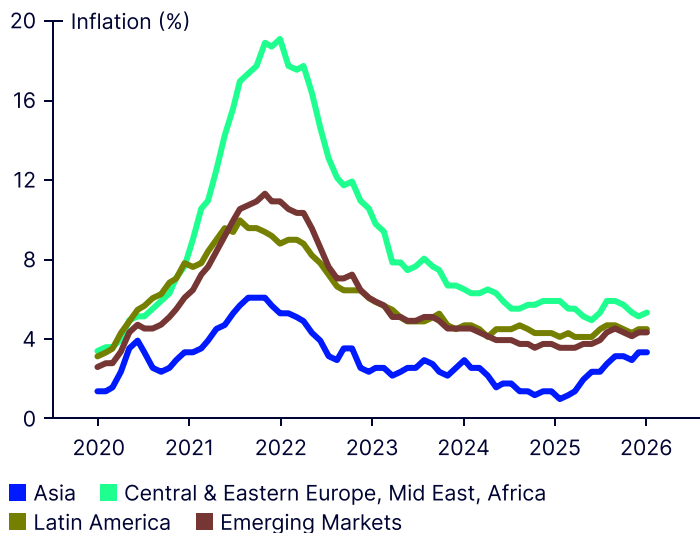
Figure 1b: EM debt returns, base currency EUR (2021–2025)



Source: State Street Investment Management, JP Morgan as of September 30, 2026. Returns are for the JP Morgan GBI-EM Global Diversified Index in EUR terms. The performance data quoted represents past performance. Past performance does not guarantee future results. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

The present inflation episode differs in both scale and composition. The energy impulse is smaller, household demand is less overheated, supply chains are more adaptable, and policy rates start from a higher, more restrictive level. Our house view anticipates that the pickup in global headline inflation seen during 2026 will ease and the disinflationary trend will return in 2027, with a more pronounced growth-inflation trade-off evident in emerging economies. This is a stagflationary complication, but not the broad-based inflation regime change seen in 2021–2022.

Figure 2: EM inflation—current shock is smaller vs 2022



Source: State Street Investment Management, Bloomberg Finance, L.P., as of September 30, 2026.

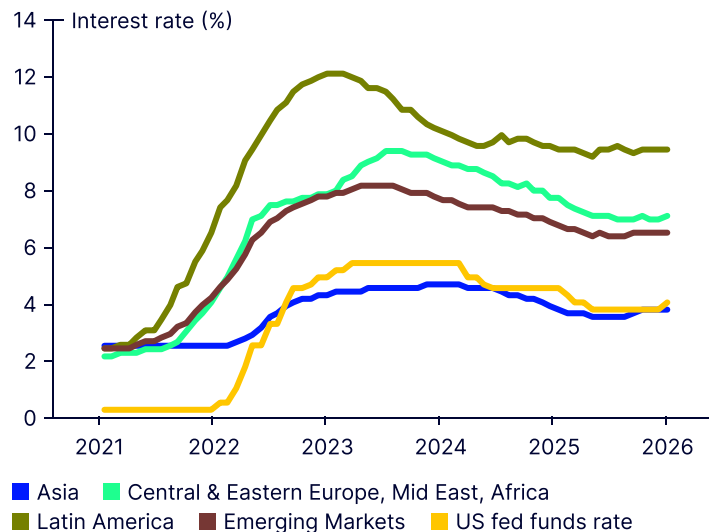
EM central bank policy buffers are stronger

EM central banks enter this episode in a stronger position because many tightened early and aggressively after the pandemic. Inflation subsequently fell back toward pre-pandemic levels, while policy rates in many markets remained restrictive. This has helped restore credibility, support currencies, and create a real rate buffer. The next steps are likely to vary by country: further rate cuts where core inflation and expectations continue to improve; pauses where elevated energy costs threatens second-round effects; and selective hikes where currency weakness or fiscal measures could contribute to inflation pressures.

Latin America: High real rates offer several central banks scope to absorb a temporary headline inflation shock, but policy flexibility varies. Brazil has a credible inflation-targeting framework operating alongside fiscal uncertainty; however, current policy may need to remain restrictive for longer if economic prospects or the currency deteriorate. Mexico can continue gradual normalization if services inflation moderates, while Colombia's stickier inflation profile argues for a more cautious approach. Commodity exposure may provide some offset through stronger terms of trade.

Asia and EMEA: Net energy importers face greater pass-through risk. Indonesia must balance imported inflation and currency stability against domestic growth. In Central Europe, weaker activity supports eventual easing, although wage growth and fiscal expansion may make policymakers cautious.

Figure 3: High EM interest rates vs US offer support



Source: State Street Investment Management, Bloomberg Finance, L.P., as of September 30, 2026.

What could change the base case assumption?

Though our base case is that the inflation spike moderates, it is worth considering how that could change and alter the approach of central banks. Policymakers will likely closely monitor four key transmission channels.

- **The duration of the oil shock:** A short oil disruption affects headline inflation, while a prolonged shock feeds through to transport, food and production costs, increasing the risk of broad inflation increases.
- **Exchange-rate pass-through:** Countries with low foreign exchange reserves, wide current-account deficits, or weak policy credibility are more exposed to imported inflation risks.
- **Inflation expectations and wages:** If households and businesses raise inflation expectations, wage demands and price rises may exacerbate the initial shock and make policy tightening more likely.

- **Fiscal responses:** Broad untargeted subsidies may temporarily suppress measured inflation but would add to budget pressures, and worsen deficits. The abrupt removal of subsidies could also produce a one-off increase in consumer prices.

Fiscal policy therefore matters mainly through the monetary policy reaction function. Budget measures that support demand, weakens debt sustainability, or undermines the inflation target may keep bond yields and policy rates high even if near-term inflation softens. Conversely, credible consolidation allows central banks to look through supply shocks without destabilizing currencies or inflation expectations. This interaction favors issuers with coordinated monetary and fiscal policy and penalizes those where fiscal dominance threatens central bank independence.

Our base case remains a temporary rise in headline inflation without triggering a synchronized EM hiking cycle. Core inflation should remain better behaved than in the 2021–2022 experience, and policy reactions should be country-specific. The key distinction will be between central banks: some will be able to pause with positive real rates, while others may be forced to defend currencies or re-anchor expectations.

Near-term outlook for emerging market debt

The comparatively healthy policy starting point leaves EM debt in a good space to absorb a moderate inflation shock, though returns could vary across EMD markets.

Local currency debt: Constructive carry, selective duration

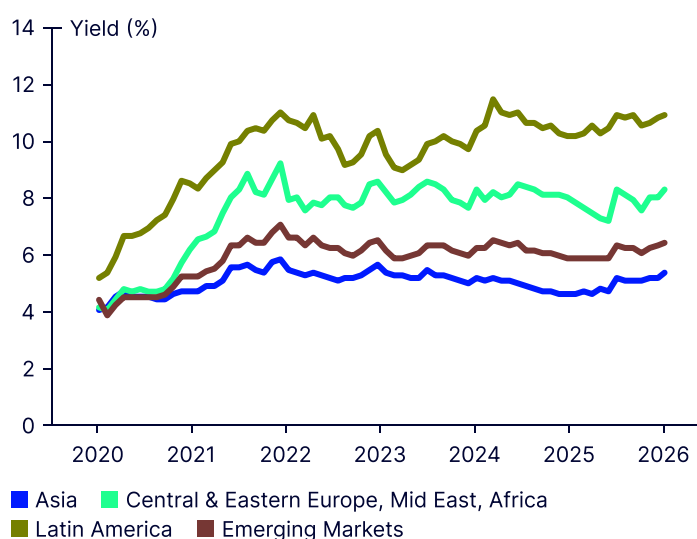
The current high yields are the principal defense against renewed volatility. If central banks merely pause policy rates at existing levels, income should provide an offset to moderate mark-to-market bond losses. The strongest opportunities may be in markets where high real yields, credible inflation targets, and disciplined fiscal policy are prevalent—the best combination of carry and eventual duration upside may be found here. Where inflation eases and yields fall, investors will benefit from bond price gains.

The strongest near-term threat to local currency debt returns is renewed US dollar strength, which could hit EM currencies and force some central banks to raise rates to preserve exchange-rate stability. Markets with robust foreign exchange reserves would be best placed in such an environment, as would countries with limited dependence on imported energy.

Hard-currency debt: Income remains supportive

Notwithstanding the recent Federal Reserve rate hike and the bank's hawkish stance, our base case envisages no large Fed hiking cycle that would leave hard currency EM debt as exposed to the type of sharp US Treasury yield increase seen in 2022. Investment-grade returns should be driven mainly by carry and US duration, while high-yield performance will remain more idiosyncratic. Tight spreads limit upside from further compression, but a moderate inflation shock need not produce negative total returns.

Figure 4: EM yields present attractive starting point



Source: State Street Investment Management, Bloomberg Finance, L.P., as of September 30, 2026.

Carry, credibility, and selectivity

Heading into the final months of 2026, the emerging market debt landscape is in more robust shape than during the 2021–2022 period. EM central banks have greater credibility and prevailing yields provide a meaningful carry cushion, even if headline inflation stays elevated for a short while. Near-term performance is likely to be positive but uneven: income rather than rapid capital gains should dominate, with policy credibility and inflation sensitivity driving dispersion.

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