Janus Henderson
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EMD HC AND THE US DOLLAR

Emerging Markets Debt Hard Currency

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A complicated relationship? Emerging Markets Debt Hard Currency and the US dollar

Key takeaways

- US dollar (USD) moves are generally considered to have a significant impact on EMs, but we believe not only has the direct impact on the Emerging Markets Debt Hard Currency (EMD HC) asset class declined in recent decades, but the impact is generally misunderstood.
- Emerging markets (EMs) have become less vulnerable to USD fluctuations due to increased local currency debt issuance, larger foreign exchange reserves, more credible economic policies, and shifted trade linkages, particularly towards China.
- While a stronger dollar generally coincides with wider credit spreads, what really matters for EMD HC is the underlying drivers of the US dollar moves. In particular, understanding the balance between the EM-US growth differential and financial conditions is likely to give a better guide.

EMD HC in a nutshell

EMD HC debt is an asset class denominated mostly in US dollars (USD), although some euro-denominated bonds are included in the universe, albeit outside typical benchmarks. Around half are investment-grade issuers, and the universe is also evenly split between net commodity importing and exporting countries.

There are more than 80 countries spread across the economic development spectrum, providing ample diversification in terms of credit risk. This translates into a fundamental resilience at the asset class level, as most global shocks are positive for some countries while negative for others. The fundamental diversification in terms of credit risk is consequently very high, providing an anchor for credit risk over the medium term.

Most of the somewhat more fragile high yield (HY) countries are in IMF programmes, with funding being conditional on programme execution, providing a strong policy anchor for the coming years. Default losses are expected to be close to zero after a round of EM restructurings completed in recent years after the pandemic.

How important is the US dollar for EMD HC?

USD moves are generally considered to have a significant impact on EMs, but we believe not only has the direct impact on the EMD HC asset class declined in recent decades, but the impact is generally misunderstood. That USD performance drives credit spreads does not seem unreasonable at first. Since the Global Financial Crisis (GFC), in years when the US dollar has strengthened, this has been accompanied by EMD HC credit spread widening more than 70% of the time[1]. However, the relevant question is whether a causal relationship exists, or if this relationship is driven by something else. We take a closer look at some of the channels through which USD moves impact EMD HC and try to uncover the possible misconceptions around how USD impacts the broader asset class.

The **direct impact** of the USD on EMD HC returns is more muted than for EM local currency debt (EMD LC), as FX moves for the latter account for a significant proportion of total returns. EMD HC is thus more resilient to swings in the USD as this does not flow directly through to daily returns. In contrast, EMD LC and EM equities have tended to perform better in a weak dollar environment.

Looking now at hard currency, the most direct impact of the USD on sovereign credit risk (the ability and willingness of issuers to pay debt) is via its impact on **EM sovereign balance sheets** and repayment capacity. Specifically, the USD affects the external debt burden. A stronger dollar increases the costs of interest and principal payments in local currency terms, worsening debt dynamics. However, there are also some indirect

[1] Source: Janus Henderson Investors, as at 31 December 2024.

effects that can be meaningful. USD performance influences growth prospects via the effects of currency pressure on inflation, which impacts monetary policy. Most EMs have in recent decades transitioned to traditional inflation-targeting regimes so central banks can respond to any pass-through from currency moves.

A stronger dollar therefore – all things equal – translates into tighter monetary policy in EM and thereby weaker growth prospects. This in turn can add to fiscal challenges and social pressure on policies, both from higher inflation and lower growth. EMs with the most credible policy frameworks can manage this at lower economic costs than those EMs with less credible policy frameworks. For EMs that have fixed exchange rates, persistent USD strength can also lead to pressure on FX reserves (or impetus to tighten monetary policy), which in extreme cases can translate into liquidity and financial stability concerns if reserves are depleted. Moreover, **the effect of the USD on credit prospects is not linear**. It often only really becomes a credit issue if the country faces a large depreciation of its currency and large debts that must be repaid in USD in the short term. This is rare but can happen.

A positive effect of USD strength (if happening in an orderly way) is that competitiveness broadly improves in EMs, while specifically for commodity exporters there is a relative gain from direct USD revenue. There is, however, a tendency for a stronger USD to be accompanied by lower commodity prices (we will get back to this later as this goes to the heart of causality), which can challenge some commodity exporters more directly.

A changed EM landscape limits USD impact

While we do not disregard the economic and financial impact from changes in the USD, EMs have come a long way since the crisis-prone 1990s. In our view, a stronger USD today has more limited direct credit implications at the asset class level as:

- **many of the larger EMs now issue most debt in local currency** (so the share of USD-denominated debt decreases as a percentage of the total),
- significant foreign FX reserves have accumulated,
- more credible macroeconomic policy frameworks have been implemented,
- and the real economic linkages to the US have declined as trade relations within EM have strengthened considerably – particularly since China has emerged as the main trading partner for many EMs.

Several decades of maturity extension and a reduction in short-term external vulnerabilities, as well as deepening local markets, have – all things equal – paved the way for more counter-cyclical policy space for countries in response to future financial market volatility and potential USD strength.

To illustrate the significant difference in terms of direct USD impact, at one end of the spectrum you find some of the large and more developed EM countries, such as China, India and Brazil, that rely predominantly on domestic funding in their own currency. India has no outstanding sovereign hard currency bonds, being represented in EMD HC benchmarks only via bonds from so-called *"quasi-sovereigns"* – companies owned 100% by the government (in this case India Exim Bank). In the case of Brazil, the domestic market is the main source of financing. At the country level, Brazil is a net creditor in hard currency, so it even gains from dollar strength due to its high foreign international reserves.

At the opposite end of the spectrum, Argentina mainly issues USD debt as it has very shallow domestic markets. In that sense, Argentina is the classical example of *"original sin"* whereby a country is effectively unable to borrow in its own currency due to weak domestic market credibility, as well as a lack of currency and inflation stability tied to a deficiency in economic policy credibility. Current president Javier Milei is currently rebuilding some of the credibility needed that will allow the free floating of the Peso and eventually lead to market access in USD. The process of building a local funding market is long and challenging for Argentina, but at the core it requires macroeconomic stability, sound macroeconomic policies and institutional credibility.

Underlying USD drivers are what really matters for EMD HC

Now when considering the somewhat less convincing direct impact of dollar moves on aggregate EM credit fundamentals, it is worth thinking about the issue of *causality*. Why is it that the USD is so good at seemingly predicting where spreads move (stronger USD, wider spreads and vice versa)? An even better predictor of credit spreads is commodity prices, but how is that the case when half of the EMD HC universe consists of commodity importers? We see strong evidence that the USD is not the main driver of credit fundamentals, but the underlying reasons behind why the USD moves in the first place can better explain EMD HC spread moves.

The credit spread moves can be best explained by changes relative to expectations in the balance between:

i) **EM-US growth differential** (proxy for broader credit fundamentals), and
ii) **financial conditions**.

The USD is more a product of that balance than a driver of it. Hence the causality does not run from USD to spreads, but from relative credit fundamentals and financial conditions. The same can be said for commodity prices that more reflect overall global growth dynamics, assuming a relatively stable supply of commodities. Obviously, uncertainty and shocks can alter the picture in any given period, but the fundamental pattern remains clear. Therefore, it is necessary to consider what kind of global environment is behind the changes in the USD, as this will influence the global flow of capital and in turn the relative performance of EM versus US assets.

Generally, **EMD HC spreads tighten when EM-US growth differentials increase** for unchanged financial conditions and **spreads widen when financial conditions tighten** without sufficient improvement in EM-US growth differentials. So, US monetary policy tightening is not a good standalone predictor of spreads but has to be considered in the context of EM credit fundamentals.

Since the GFC, Fed Funds rate movements have had little predictive power over spreads. Hence, EMD HC spreads tightened during 2016 and 2017 when the US was tightening monetary policy as EM fundamentals were improving due to a synchronised global recovery. If EM-US growth differentials trend lower, the asset class needs financial conditions to ease to avoid spread widening and generally this environment is more challenging for EMD HC – in particular relative to comparable US asset classes. In intuitive terms, this balancing act means that when EM credit fundamentals are not synced with US credit fundamentals, financial conditions (determined predominantly by the Fed) will not match corresponding EM credit fundamentals which leads to EMD HC spreads moves. I.e. wider spreads if financial conditions are too tight and vice versa. This is a very simple fundamental relationship that can be interrupted by uncertainty and unexpected shocks, but EMD HC has generally exhibited a strong credit anchor that historically has led to relatively quick reversals of the spread to what is predicated by credit fundamentals.

Scenario analysis

We now list some scenarios overleaf and our thoughts on how EMD HC behaves, given those different aspects. These are of course all things equal and some of these views are very sensitive to scenario-specific assumptions. In terms of the direction of capital flows, empirical evidence suggests that the following push factors are key: interest rate differentials, developed economy growth outlook, global risk appetite and global liquidity conditions. Pull factors are EM-specific factors that can attract capital flows and include growth prospects (credit fundamentals more broadly), local return prospects, structural reforms, policy improvements, institutional improvements and political stability.

Figure 1: EMD HC drivers – possible scenarios and outcomes

Scenario	EM-US growth differential	Fed policy stance	Global market sentiment	Capital flows	Likely USD direction	Rationale
Global recovery (2016–2017, 2021)	Stronger	Dovish	Positive	Flows to RoW	Weaker	Global risk on and diversification weakens USD
Global recession (short one in 2020)	Mixed	Dovish	Negative	Flows to US (safe haven)	Stronger	Global risk off and flow to safe-haven benefits USD
US exceptionalism (most of the recent past)	Weaker	Hawkish	Neutral to positive	Flows to US	Stronger	US assets enjoy safe-haven and growth advantage
US policy uncertainty (elevated under the two Trump administrations) 2018 and 2025 in particular	Stronger depending on policies	Cautious Reactive	Unpredictable Volatile	Flows to RoW	Weaker Volatile	USD confidence shaken, higher volatility and emphasis on diversification. Potential disruption of classical flow patterns and questioning of safe-haven USD status
Fed behind the curve (to loosen) due to inflation uncertainty	Stronger	Dovish too slow	Negative Uncertain	Mixed with a tilt to flows to RoW	Weaker	US recession concerns weigh on US assets. Can be amplified by political pressure on the Fed
Synchronised policy tightening	Equal to stronger	Hawkish globally	Neutral	Balanced	Range-bound	Balanced move in USD as global central banks move together, reflecting similar fundamentals. EM less financialised so bias to higher EM-US growth differential
US overheating/ decoupling (2014-2015, 2018)	Weaker	Hawkish Credibility risk	Neutral Negative for EM	Flows to US	Stronger Volatile	Strong US growth attracts flows but also fear of Fed policy mistake impacts USD
US debt and twin deficit stress (2025)	Mixed	Cautious due to fiscal impulse but dovish	Negative	Flows to RoW, less demand for UST	Weaker	High fiscal and current account deficits weigh on USD and uncertainty about safe-haven status.

Source: Janus Henderson Investors. RoW: Rest of the world. UST: US Treasuries. Fed: US Federal Reserve. **There is no guarantee that past trends will continue, or forecasts will be realised.**

The important signal from the USD is one of relative attractiveness of US assets to RoW assets, of which EMs are a dominant part. Consequently, the direction of capital flows is highly correlated to the view of the USD. If the USD is stronger due to higher US interest rates, with the US economy outperforming the RoW, EMD HC spreads are likely to drift wider as financial conditions become too tight for the level of EM fundamentals. This is one of the most hostile environments for EMD HC as capital will tend to flow out of EMs and towards the US, with corresponding wider spreads and even upward pressure on US Treasury yields, adding to the damage in total return terms.

EMD HC and EMs have historically experienced collateral damage at times of broader risk aversion in global financial markets, due to the US being the primary safe-haven destination. Even when shocks are unrelated to EM credit fundamentals, sovereign spreads have tended to widen for a period before mean reverting to levels consistent with fundamentals. In other words, a strong credit anchor exists in EMs if shocks and uncertainty do not significantly impact underlying credit fundamentals.

Confidence shock to US policy

This traditional push-pull framework for understanding capital flows frames the current situation. If a policy uncertainty shock comes from the US itself, it is likely to change how capital flows behave and disrupt the traditional push factors to potentially benefit EMs. Recent market stress has been driven by US policy uncertainty, which has led to debate about US policies becoming less rules-based under President Trump.

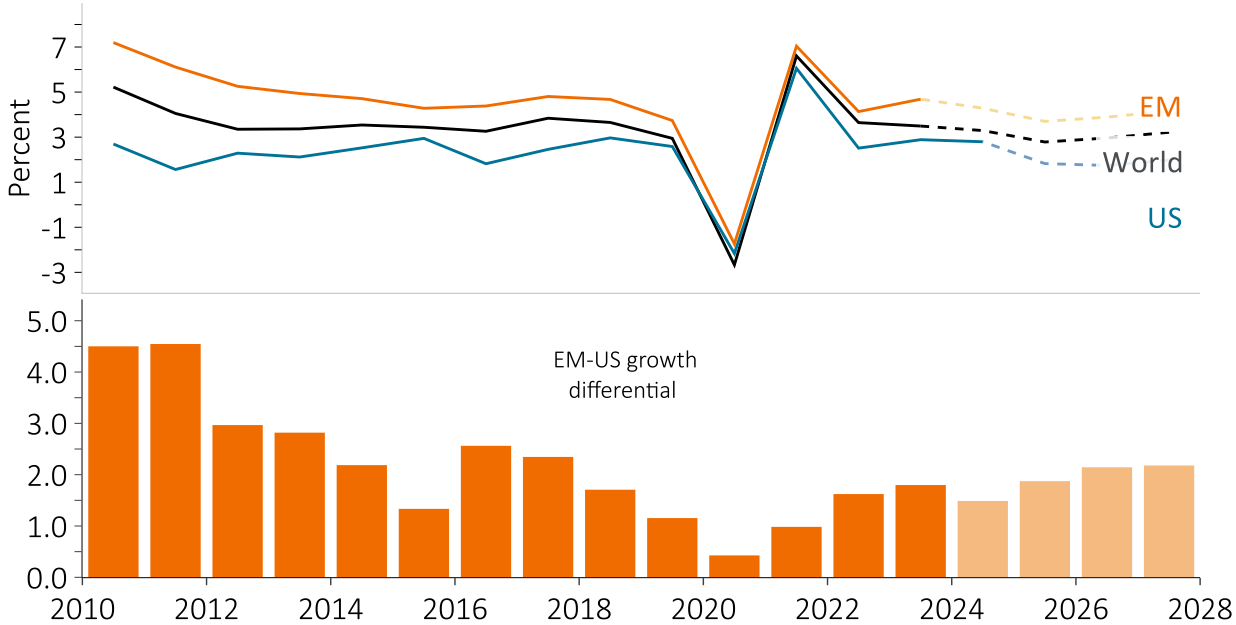
More unpredictable policies, institutions, or long-term strategies could lead to a broader re-think of the pillars of exceptionalism. This can disrupt the traditional safe haven association with the US and lead to some re-allocation of capital from the US to the RoW. While the confidence shock would be negative for financial markets broadly, EMs could be somewhat insulated given the epicentre is in the US. We have already seen a tendency for the USD to respond differently compared to history, as have US Treasuries.

Where to now?

In terms of prospects for the USD, while Trump wants lower inflation and a weaker USD, many of his policies, such as tariffs and potential fiscal expansion, work in the opposite direction, resulting in a tug of war. The higher level of underlying US Treasury yields today provide some offset to wider credit spreads, should the outlook deteriorate from here.

In the current environment of a weaker USD, EMs are enjoying more monetary policy space as disinflation is more likely to continue and central banks can lower policy rates as inflation comes down. A weaker USD generally allows other countries to implement more counter-cyclical policies, and this is also supportive of the cyclical prospects for EMs. Hence, we expect the growth differential between EMs and developed economies, and the US in particular, to **increase** (Figure 2)**.**

Figure 2: EM-US growth differential set to increase



Source: Janus Henderson Investors and Macrobond, as at 16 June 2025. IMF projections shared in the World Economic Outlook, GDP estimates, constant prices. 2024, 2025, 2026, 2027 are forecasts. **There is no guarantee that past trends will continue, or forecasts will be realised.**

Fiscal concerns in the US have been a headwind for EMs as it has pushed US Treasury yields higher. However, to get meaningfully higher rates from here would require a massive change from the Fed towards reconsidering rate hikes, which is not expected (but could occur if there was another inflation shock). The room for further increases in US rates currently appears far more limited. In a world where everything is relative, **EM suddenly looks a whole lot better, and we believe it will act as an important diversifier** within portfolios**.**

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