



War and peace

From Emerging Market Debt

The war involving Iran has unleashed a sharp supply shock that extends well beyond oil and gas. Disruptions now affect a broad range of petrochemical products, from fertilizers to helium, compounding pressure across global production chains. Prices reacted swiftly: Brent crude traded well above \$100¹, while freight rates surged as shipping routes adjusted to constrained passage through the Strait of Hormuz.

More recently, however, markets have responded positively to the agreement on a two-week ceasefire and the reopening of the Strait of Hormuz. Brent crude has fallen back below \$95¹, while sovereign credit, rates, and FX markets have rallied sharply as investors unwind some of the geopolitical risk premium that had built up during the conflict. That said, it is still too early to conclude that the shock has fully reversed. Much will depend on whether the ceasefire holds, whether shipping flows normalize in practice, and whether negotiations continue to move toward a more durable de-escalation.

The macro impulse from Iran war is stagflationary. Rising input costs threaten to slow growth just as inflationary pressures begin to re-emerge, placing policymakers in an increasingly uncomfortable position. However, the economic fallout is far from uniform. The shock is reinforcing a familiar fault line between net energy

exporters and net energy importers, a divergence that is particularly pronounced across emerging markets.

The rally in oil prices inevitably revives memories of 2022, when Russia's invasion of Ukraine triggered a sharp spike in energy prices and a broad-based sell-off across emerging market assets. That episode exposed vulnerabilities in external balances, pushed inflation sharply higher, and coincided with rapid tightening in global financial conditions. Market stress was swift and indiscriminate: sovereign spreads widened by roughly 140bp¹ within weeks as investors reassessed risk across the asset class.

So far, the reaction has been notably more restrained. Since the start of the current conflict, emerging market sovereign debt spreads at the time of writing roughly 25bp wider compared with end February¹. This more measured response reflects a fundamentally different starting point. Global interest rates are already much higher, fundamentals have been on the mend, and investor positioning is less crowded.

Market pressure has also been more selective. Stress has concentrated in countries with direct exposure to the conflict and among structurally vulnerable energy importers. In contrast, oil exporting economies, particularly those outside the immediate theater of conflict, have generally outperformed.

1. JP EMBIG Index, via Bloomberg

EM sovereign debt spread



Source JPM EMBIG Index, via Bloomberg

Taken together, these dynamics argue for caution rather than alarm. While geopolitical uncertainty and elevated energy prices warrant close monitoring, current conditions do not point to a repeat of the broad-based emerging market dislocation seen in 2022. This adjustment is more targeted, reflecting both the nature of the shock and a markedly different global macro and market backdrop.

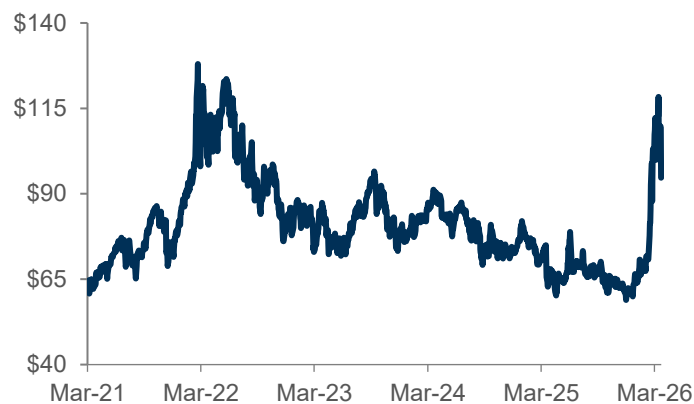
Emerging markets show increased fundamental resilience

Emerging markets were once among the most vulnerable segments of the global economy, prone to sudden stops in capital flows that triggered currency collapses, inflation spikes, and painful policy tradeoffs. Over time, however, the asset class has evolved. Stronger monetary frameworks, more credible fiscal policies, more flexible exchange rates, and tighter financial regulation have materially improved resilience.

The stress tests of recent years, from the pandemic to the global rate shock of 2022, exposed weaknesses but also forced adjustment. Many sovereigns responded by tightening policy, allowing greater exchange rate flexibility, rebuilding foreign exchange reserves, and strengthening balance sheets, often through IMF led programs. As a result, a number of emerging markets enter the current shock with meaningfully stronger buffers than in the past.

That said, a new test is now taking shape. Governments across emerging markets are moving to cushion the impact of higher energy costs through subsidies, tax cuts, and other interventions that provide near term relief but risk slowing fiscal consolidation. Measures to curb energy demand may help limit inflation in the short run, but if sustained, they could weigh on productivity and medium term growth.

Crude oil price | Price per barrel



As a result, even though fundamentals are stronger, we believe a prolonged shock would still revive familiar pressures: strained public finances, draws on foreign exchange buffers, and higher costs of external borrowing, all against the backdrop of debt burdens that remain elevated relative to pre pandemic levels.

The longer the conflict persists, the greater the drag on fiscal accounts

If the shock were to persist, fiscal risks across emerging markets would inevitably rise. For now, however, the impact appears contained. Many EM countries enter this episode with stronger fiscal frameworks than in the past, providing useful safeguards against abrupt deterioration. The main areas of vulnerability lie among net energy importing economies with a history of intervening in fuel, electricity, and other energy related markets, where subsidies and tax relief can quickly erode public finances if elevated prices endure. These risks are amplified in countries with weaker external positions, particularly where subsidy reform remains incomplete or political constraints complicate adjustment.

By contrast, fiscally stronger economies are better placed to absorb temporary intervention, while net energy exporting emerging markets remain relatively well insulated. In parts of Latin America, Africa, and Asia, higher commodity revenues provide a meaningful offset, helping to contain the fiscal cost of support measures. This divergence underscores a broader reality: resilience across emerging markets is no longer uniform, but increasingly shaped by energy exposure, policy credibility, and the willingness to prioritize medium term stability over near term relief.

That said, a new challenge is beginning to emerge. Governments across emerging markets have already begun deploying measures to cushion the impact of higher energy prices: steps that carry a fiscal cost. Fuel subsidies and tax cuts may offer short term relief, but they weigh on budgets at a time when fiscal consolidation remains challenging for many sovereigns. As a result, even with stronger fundamentals and energy prices still below the extremes of 2022, a prolonged shock would bring familiar pressures back into focus: widening fiscal strains, increased reliance on foreign exchange buffers to smooth currency weakness, and higher external financing costs, all against a backdrop of debt burdens that remain elevated relative to pre pandemic levels.

Markets turn hawkish, but central banks remain in wait and see mode

The current supply disruptions pose a risk of a synchronised tightening of monetary policy across emerging markets, as central banks move to anchor inflation expectations and shore up financial stability. That risk cannot be dismissed should energy disruptions persist. For now, however, EM central banks are more likely to adopt a largely wait and see approach rather than risk responding to the supply driven shock prematurely. This is supported by the elevated real policy rates across emerging markets providing room to assess the fallout before adjusting monetary policy.

In addition, demand pressures are far more contained than in 2022, reducing the risk of second round effects that were a key driver of inflation during that episode. Back then, energy price shocks coincided with post pandemic reopening, strong fiscal support, high accumulated savings and strong wage growth. Today's environment is very different, with softer labour dynamics and tighter financial conditions limiting pass through into wage-inflation cycle.

Both factors suggest that current market pricing overstates both the likelihood and the scale of EM policy tightening. Recent moves in rates markets appear driven more by positioning, and short term dislocations than by a realistic

assessment of central bank reaction functions. Provided the shock does not prove long lasting, fiscal deterioration should also remain manageable, limiting the risk of a sustained need in monetary policy tightening.

Alpha opportunities in EM sovereigns.

Amid heightened market volatility driven by geopolitical risks and sharp swings in commodity markets, our focus is on countries where fundamentals are improving and where political developments, market access, and rating trajectories offer asymmetric upside. In this context, we hold a constructive view on Ecuador and Argentina. In both cases, strong political commitment to reform under IMF programs is reinforced by constructive relations with the United States, providing an important external anchor. As commodity exporters, both countries also stand to benefit from higher prices, improving the macro backdrop.

We are similarly encouraged by recent polling in Hungary, which suggests that the opposition has a credible chance of winning next year's elections. We believe markets appear to underprice the probability of a favourable political outcome that could unlock EU fund flows and materially improve the outlook for local assets, creating asymmetric upside potential. We also see value in Suriname, where recent liability management efforts have addressed key investor concerns and offer attractive compensation for investors willing to support a multi year reform agenda.

Beyond these cases, we expect continued rating improvements in Ivory Coast, supported by robust economic growth and improved macro stability. We also believe the relative value in oil exporting economies such as Angola and Nigeria, where higher energy revenues provide a buffer, and where Nigeria in particular, is showing encouraging progress on fiscal reforms and tax collection. Finally, in Romania, while downgrade risks persist, current valuations more than compensate investors for this uncertainty, offering what we believe is an attractive risk reward profile at current levels.

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JMP EMBIG Index — The J.P. Morgan Emerging Markets Bond Index (EMBI) is a family of benchmark indices tracking liquid, U.S. dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities. They measure total return performance, including Brady bonds, Eurobonds, and traded loans, acting as a standard for portfolio management in this sector

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