EM Local Rates

Navigating Growth Rotation

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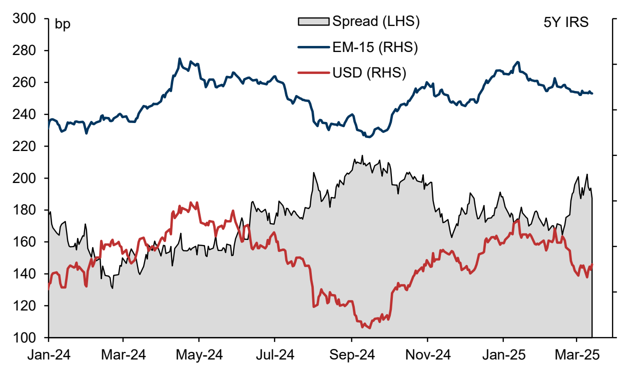
- **Pricing-In Weaker US Growth – a Constrained Tailwind for EM Rates.** The US rate rally driven by souring US growth expectations has provided limited relief to EM local rates. Part of this is the risk-off nature of the US rate rally that has constrained the extent to which high-beta EM markets have been able to rally. For this to change, we think we would need to see more dovish signs coming out on the US policy front, either trade or monetary policy. However, we do not think that this week's FOMC meeting will provide sufficient signaling to fully alleviate market growth worries, and we think that in this environment, local rates in low-yielders in Asia, India, and Chile would have an easier time to price a more dovish backdrop. By contrast, if we were to see more dovish signals from the Fed, we think that markets that have lagged behind, such as South Africa, Indonesia and Hungary would likely stand to benefit more. Beyond the Fed, we think that a softer US Dollar and lower oil prices are also likely to ease the constraint on EM central banks that could open up room for more dovish pivots.
- **Taking German Fiscal News Seriously — More Steepening in the CEE**. The magnitude and the scope of the German fiscal package could mark a watershed moment for the European economic and markets outlook. For CEE rates, we think that this should reinforce ongoing steepening dynamics. For one, improved Euro Area growth repricing could provide more support for CEE FX that would give relief to the CEE front-ends. By contrast, the long-ends across the region could come under more pressure here amid a higher European rate repricing. That said, we think that there would be limited scope for the market to increase fiscal risk pricing for the region in excess of the repricing in Bunds, and we see room for some tightening in the CEE local bond-Bund spread. Taken together, we continue to like positioning for steepening across the region, with Poland as our preferred market to play this theme.
- **Local Rate Expressions For This Macro Backdrop**: Steepeners in Poland, front-end receivers in India, continue to like receivers in Chile within LatAm.

Navigating Growth Rotation

US Growth Downgrade — A Constrained Tailwind for EM Rates

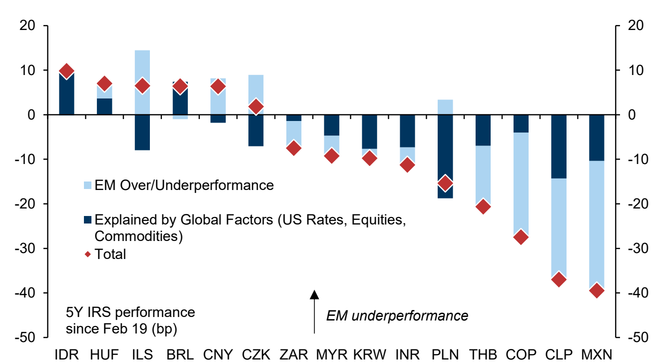
- **Underperforming in a Growth Rotation.** EM local rates have played second fiddle in a rotation in market repricing, with the market downgrading the US growth outlook weaker while upgrading relative growth prospects elsewhere. Amidst these shifts, EM rates, at least in aggregate, have underperformed the rally in US rates (after outperforming during the sell-off early in the year) (Exhibit 1). There is a strong regional dimension to this (Exhibit 2), with rates in China underperforming amid stronger policy signals surrounding fiscal and economic support measures, as well as in the CEE region, where the large German fiscal stimulus and the sell-off in Bunds has translated to hawkish pressures in the region. Set against this, rates in LatAm have fared better, most clearly in Mexico and Chile. In the case of local rates in Chile, we flagged a few weeks ago that the market had overshot pricing the next moves by the BCCh as a sequence of rate hikes, and think that the recent front-end led rally brings rates closer to more balanced levels. Still, for the EM rate performance going forward, we think that it will be important to gauge the extent to which these growth worries become sustained in the US, and, arguably more important, whether it invokes a more dovish policy response (either from the Fed or more benign signaling on the tariff front).

Exhibit 1: EM Local Rates in Aggregate, Have Lagged Behind the Rally in US Rates
Average EM-15 5Y rate versus US 5Y SOFR



Source: Goldman Sachs Global Investment Research, Bloomberg

Exhibit 2: Underperformance of CEE, China and Brazilian Rates, Outperformance in Rest of LatAm
Decomposition of 5Y IRS performance since Feb 19

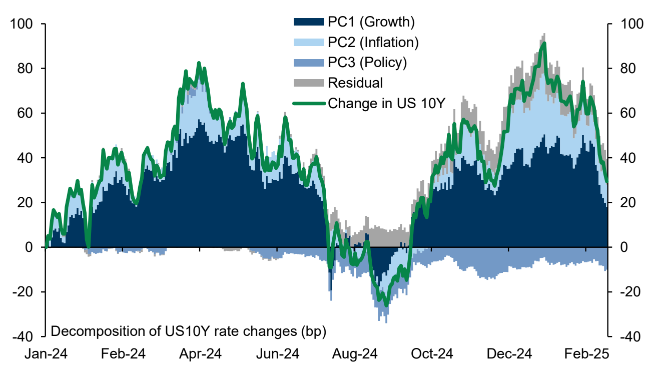


Source: Goldman Sachs Global Investment Research, Bloomberg

- **Different Shades of US Rate Relief — Growth downgrade led US rate relief provides limited support to EM high-yielders**. We have been arguing that for EM local rates, the spillovers from lower US yields depend on the source of the US rate move. Namely, growth downgrade led moves (yields down, equities down), as opposed to inflation or Fed policy led rate relief (yields down, equities up), tend to offer less relief for EM rates, given the risk off of nature such repricing. To illustrate this, Exhibit 3 shows a PCA decomposition of change in UST 10Y to factors associated to market pricing of growth, inflation and policy, which highlights the extent to which the most recent repricing has been primarily about shifting growth expectations. If we bring these factors to EM rates, we find that for high yielders (e.g. Brazil, Colombia, Indonesia, Hungary and South Africa) the sensitivities are relatively low to US rate led moves that are driven by growth (Exhibit 4). In Colombia in particular, the risk-off environment, combined with declining oil prices and negative news on the inflation front, has put pressure across the curve, and last week we closed our 5Y IBR receiver for a small potential gain. By contrast, low-yielders in Asia, India, Chile and Czech, tend to benefit from such repricing and see more follow-through. Given these dynamics, we think that the signaling from this week's Fed meeting will be important, and we think that any signs of an acknowledgment or responsiveness to deteriorating market and economic sentiment could provide some cushion to risk assets and support a more constructive response in the high-yield laggards amid the US rate rally.

Exhibit 3: Downgrade in Growth Expectations Behind Falling UST 10Y rates

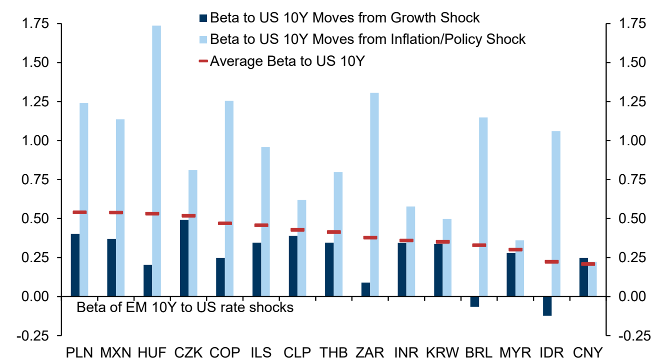
PCA based factor decomposition of changes to UST 10Y rates



Source: Goldman Sachs Global Investment Research

Exhibit 4: EM Local Rates, Espescially For High Yield, Tend to be More Sensitive to Inflation and Policy-Led Repricing in US Rates

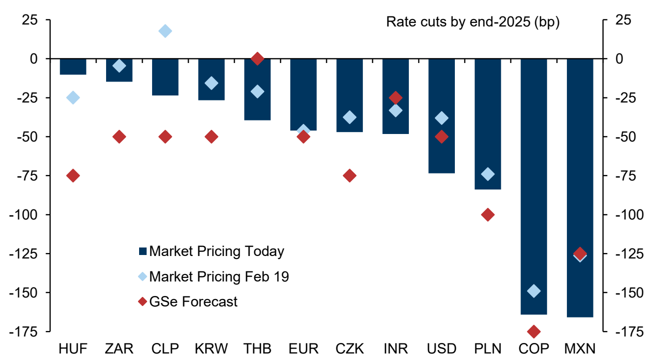
Estimated over a sample covering the last two years



Source: Goldman Sachs Global Investment Research

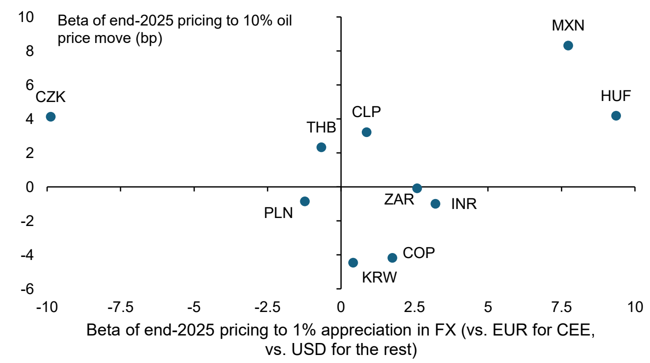
- **Risk-Off Without a Strong Dollar Lifts External Constraints on EM Central Banks – support for the front-end of the curve in India, Indonesia, Mexico and Chile.** The negative growth repricing has also led to a shift in market expectations around the Fed rate path for this year, with the market pricing an additional rate cut to a total of around three rate cuts by the end of this year (Exhibit 5). The market's ability to add more near-term rate cuts has been constrained by the potential inflationary implications of tariffs, and the muted US rate market response to the downside CPI release last week was telling. It is unclear how high the bar is for the Fed to respond to negative growth news and last year's experience suggests that there is limited appetite within the Fed to fall behind the curve given growth news. But for EM central banks, we think that this may further relax the external constraints on responding to their domestic cyclical signals. In particular, it might further support front-end pricing in Mexico, where while the market has run quite far already, both the data and the FX performance have allowed the market to price a deeper rate cutting cycle from Banxico. One feature of the recent market sell-off that should support EM front-ends is that the fall in equities has come with US Dollar weakness, which should relax the external constraint that has been more binding, particularly to central banks in Asia (e.g. RBI in India, BOK in Korea and Bank Indonesia). Likewise, for others, the pronounced decline in oil and energy prices might represent a more important disinflationary tailwind, which could reduce, for example, some of the hawkish pressures in the CEE front-ends as well (Exhibit 6). Taken together, we see room for EM central banks to turn more dovish in this environment, and within the asset class we continue to like front-end rates in India (receiving 2Y ND-OIS), Indonesia (being long 1Y SRBI's FX-hedged) and would see further scope for front-end rates to continue to perform in Chile, where we see scope for the market to add to rate cut pricing.

Exhibit 5: The Market Has Increased Rate Cut Expectations for the Fed, Less So in EM
Market pricing of rate cuts by year-end (latest vs. Feb 19 and GSe forecast).



Source: Goldman Sachs Global Investment Research, Bloomberg

Exhibit 6: MXN, CLP, THB and CEE Rates To Benefit From Lower Oil Prices, Weaker Dollar to Support MXN, HUF and INR Rates
Sensitivity of market pricing of end-2025 rate cuts vs, changes to FX and Brent oil prices.



Estimated on weekly frequency, since start of 2024 to latest

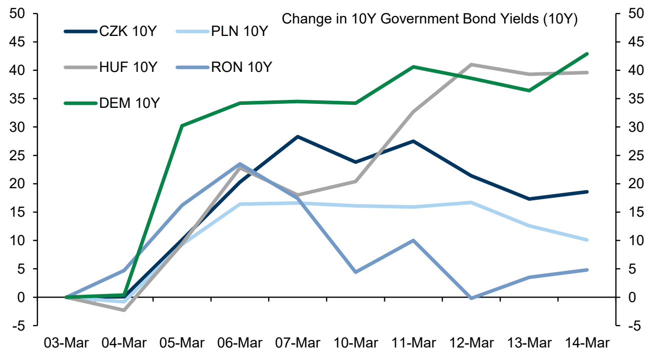
Source: Goldman Sachs Global Investment Research

Taking German Fiscal Seriously — More Steepening in the CEE

- **German Fiscal News — A Brave New World**. The announced German fiscal expansion marks a watershed moment for the Euro Area economic and markets outlook. On the back of the news, we have raised our Euro Area and German growth projections higher, fiscal deficits wider, and have raised our 10Y Bund forecast to 3.00% by end-2025 and 3.25% by end-2026. The markets have priced the news rapidly, propelling 10Y Bunds significantly higher to close to 3.00% as well. The speed of the move has also taken CEE local rate curves higher (Exhibit 7), although as the market had more time to digest the news, we have seen a more differentiated and nuanced response. On net, while the long-end yield level is higher across all of the rate markets, spreads versus Bunds are now tighter in Czech, Poland and Romania, unlike European sovereign spreads that are only marginally changed (Exhibit 8). In this section, we gauge whether the relative CEE local rate outperformance is warranted and the outlook going forward if we were to take the developments in Germany seriously.

Exhibit 7: Broad Based Sell-off in the CEE Long-Ends During Initial News, More Mixed Performance Afterwards

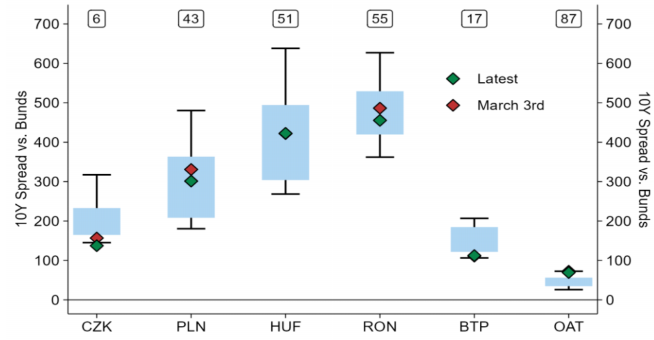
Daily performance of 10Y bonds in the CEE region vs. Bunds



Source: Goldman Sachs Global Investment Research

Exhibit 8: Local Rate Spreads in CZK, PLN and RON Have Tightened Versus Bunds

10Y government bond yield spreads vs. Bunds. Light blue area 25-75th percentiles, error bars 10-90th percentiles; number above indicates latest percentile; 5-year lookback

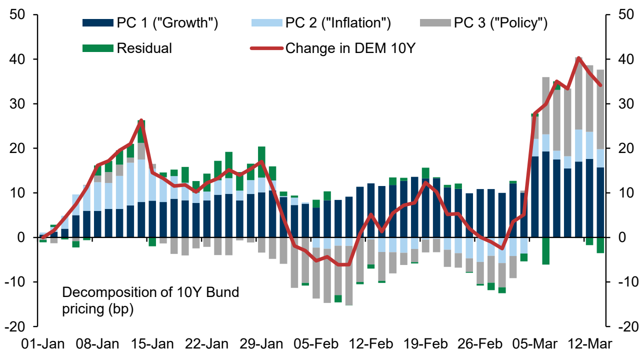


Source: Goldman Sachs Global Investment Research

- **Relative European Growth Pricing in CEE Rates More Mixed Due to FX.** The market repricing of Bund yields higher embeds a number of factors – from potentially better cyclical growth prospects in Europe as well as higher fiscal risk premia. Indeed, by decomposing the Bund performance into different factors, we see a relatively balanced repricing across components (Exhibit 9). Focusing, however, on the growth factor and the potential of a cyclical upgrade of European growth, we find that the implications of this for CEE rates are more mixed (Exhibit 10). Specifically, we find that improved European growth pricing tends to boost CEE FX, which partly blunts the hawkish impact on CEE rates from higher European rates. This distinction is the clearest in Hungary, where policymakers and the local rate markets tend to be more sensitive to FX developments in general. More broadly, however, we think that there are more limited hawkish implications to the CEE front-ends from improved cyclical repricing in Europe. We had been arguing that CEE local rates had not embedded a lot of cyclical downside leading up to this, whereas the strong performance of the CEE FX (Exhibit 11) is already causing a pushback from CEE policymakers. We therefore think that further currency strength could bring forward some of the rate cuts in the region, rather than push them out (Exhibit 12). A more important hawkish cyclical offset to this would likely have to come from the ECB in the event it stops its easing cycle at a higher terminal rate than what the market is currently pricing (above 2.00%).

Exhibit 9: Repricing in the 10Y Bunds Driven by a Multitude of Factors

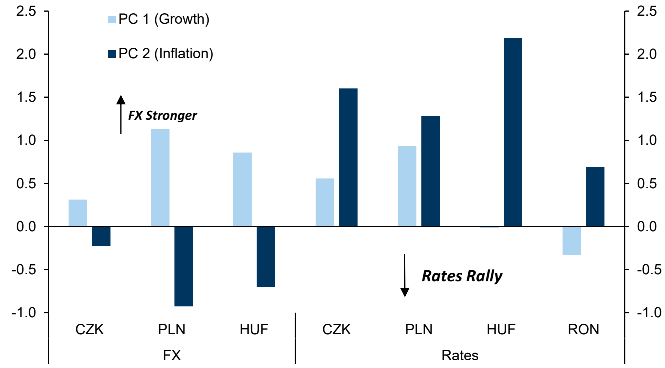
PCA based factor decomposition of changes to 10Y Bunds rates



Source: Goldman Sachs Global Investment Research

Exhibit 10: Positive European Growth Repricing Tends to be Reflected in Both FX and Rates

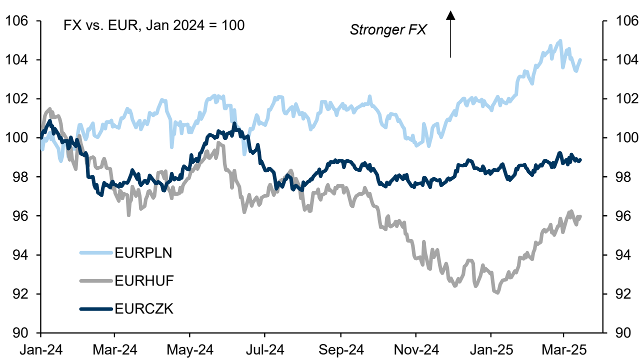
Sensitivity of the CEE FX (vs. EUR; 10bp move) and 5Y Rates (1bp) to Bund repricing that is driven by the growth and inflation factor



Source: Goldman Sachs Global Investment Research

Exhibit 11: CEE FX Had Been Strengthening Leading Up to the German Fiscal Announcement

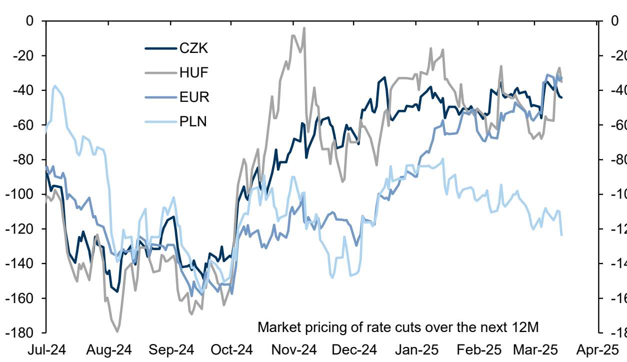
Index of the CEE FX vs. EUR (Jan 2024=100)



Source: Goldman Sachs Global Investment Research, Bloomberg

Exhibit 12: The Market Has Reduced Rate Cut Pricing in Czech and Hungary, But Has Increased in Poland

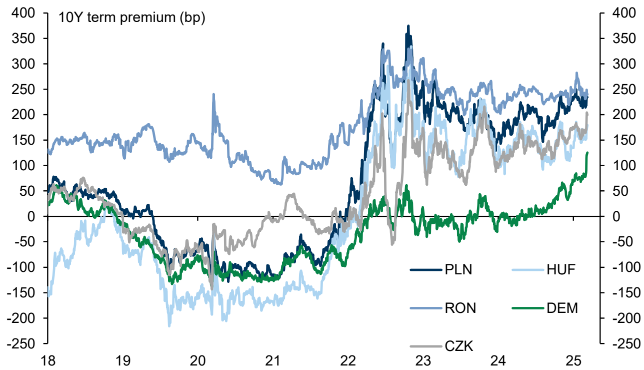
Difference between 3M rates and 12x15 FRAs



Source: Goldman Sachs Global Investment Research, Bloomberg

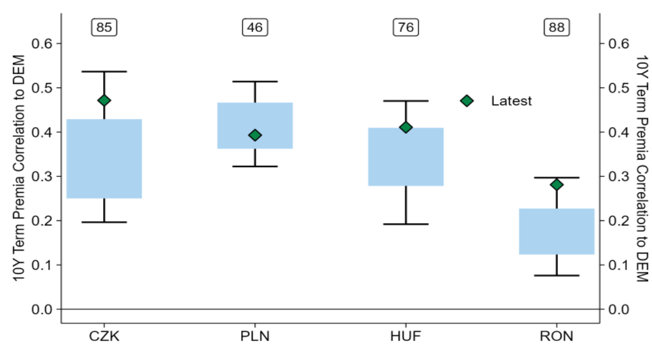
- **CEE Long-End Risk Premium – A Larger Buffer, But Still Exposed**. The CEE long-ends have traded with a meaningful discount relative to Bunds since 2022 (Exhibit 13). Measured through our term premia pricing, long-end spreads in the CEE have diverged from Bunds amid the inflationary shock and fiscal expansions that have come with it. This risk premia has persisted even as inflationary risks have moderated in the region. More encouragingly, even as the risk premium in Bunds has built-up, the CEE long-ends have been more insulated, likely reflecting this buffer. That said, on a more short-term basis we find that CEE long-end risk premia tend to be sensitive to Bund repricing which suggest that we should still expect more long-end pressure from additional increases in Bund yields (Exhibit 14). Within the CEE region, the long-end in Czech tends to exhibit the highest sensitivity, whereas Poland and Romania have tended to trade with a reduced sensitivity to the repricing in Bund risk premia.

Exhibit 13: Persisting Long-End Risk Premium in the CEE Since 2022
10Y term premium estimates



Source: Goldman Sachs Global Investment Research

Exhibit 14: Czech Long-End More Sensitive to Bund Risk Premia, Compared to Poland and Romania
Correlation of the CEE 10Y term premia with Bunds term premia; Light blue area 25-75th percentiles, error bars 10-90th percentiles; number above indicates latest percentile; 10 year lookback

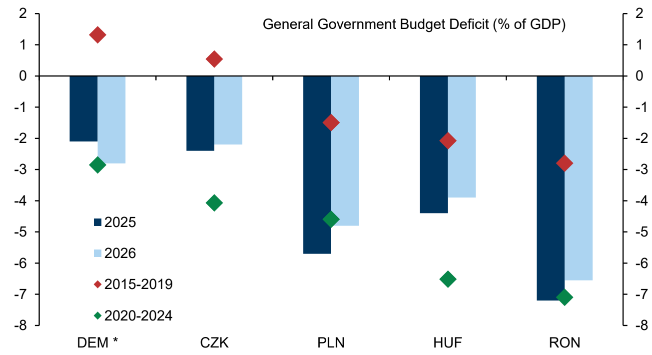


Source: Goldman Sachs Global Investment Research

- **Less Scope for a Fundamental Downgrade of the CEE Region, Easing in Inflation Risks and European Rate Repricing to Support an Ongoing Steepening in CEE Rates.** Notwithstanding market sensitivities to trading European risks, one open question is whether the latest German fiscal news will warrant a re-assessment of CEE fiscal fundamentals as well. We do not think so, as to some extent the CEE region had already front-run the fiscal expansion (e.g. Poland is already spending in excess of 4% of its GDP on defence). There could still be some slippage relative to market expectation given a relatively busy election period this year in the region. However, we see less scope for a similarly large fiscal announcement as in Germany. By contrast, as we discussed before, we think there is scope for the CEE region to benefit from European energy price relief, that should provide some tailwind for CEE inflation and front-ends. Taken together, we think that developments should support a steepening of CEE curves. We think that Polish rates have the most room for the steepening to play out further, and there's more to come from the downside surprise to inflation last week. By contrast, we think that the long-end sell-off in Czech has gone too far and on a risk-adjusted basis, we see the long-end in Czech as relatively more attractive to others, albeit potentially more vulnerable to any further hawkish repricing in European rate markets. We also think that the fundamental backdrop in the CEE region should support a narrowing in CEE rates spread with Euro Area rates.

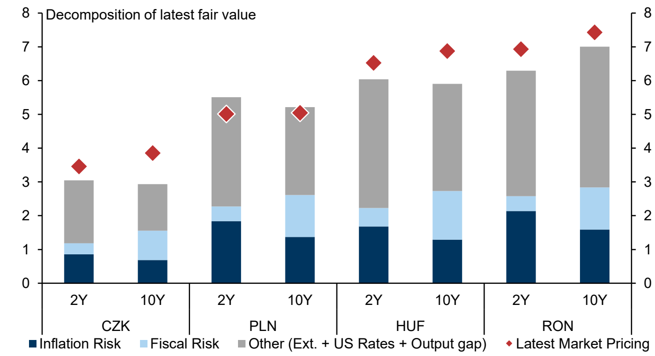
Exhibit 15: German Fiscal Widening Against Fiscal Consolidation in the CEE

General government budget deficit as % of GDP ('15-'19 & '20-'24 averages), Bloomberg consensus estimates for 2025 and 2026, GSe forecasts for DEM



Source: IMF, Goldman Sachs Global Investment Research, Bloomberg

Exhibit 16: Value in Czech Long-End, High Risk Premium in Hungary, Scope for Continued Steepening in Poland if Inflation Risks Get Priced Out



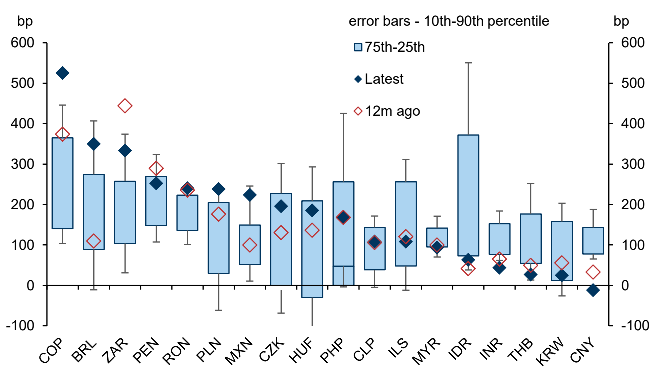
Inflation risk - short-term & long-term inflation expectations; fiscal risk - current and expected debt path based on market expectations

Source: Goldman Sachs Global Investment Research

The authors would like to thank Emilia Illinger for her contribution to this report. Emilia is an intern in the Markets team.

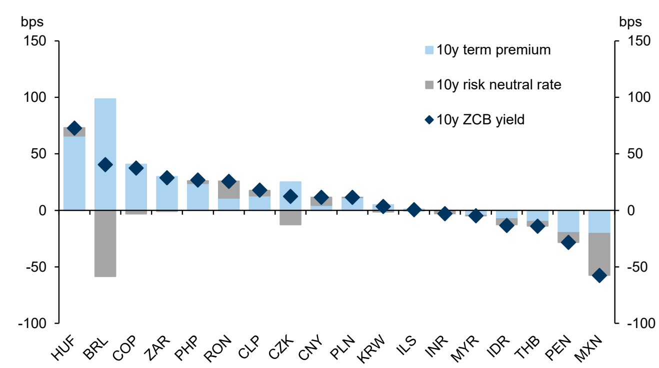
Indicator Appendix

Current 10-year local bond term premia estimates vs. historical interquartile range



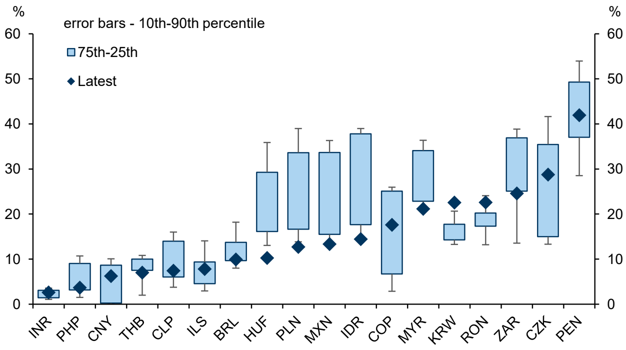
Source: Bloomberg, Goldman Sachs Global Investment Research

Decomposition of last three-month 10y rate changes in risk-neutral rate and term premium



Source: Bloomberg, Goldman Sachs Global Investment Research

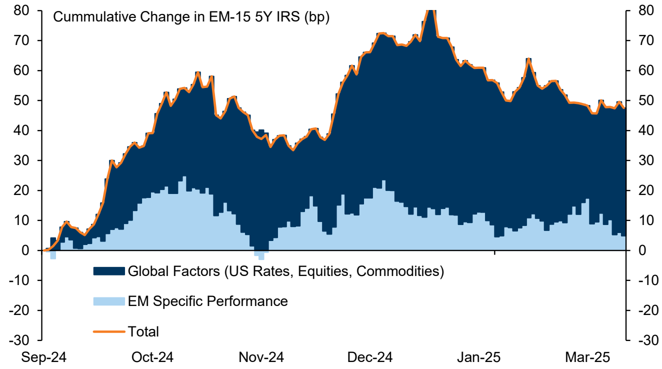
Local government bonds foreign ownership vs. last 16-year range



Source: Haver Analytics, Goldman Sachs Global Investment Research

Contribution of local and global shocks to aggregate 5Y IRS performance

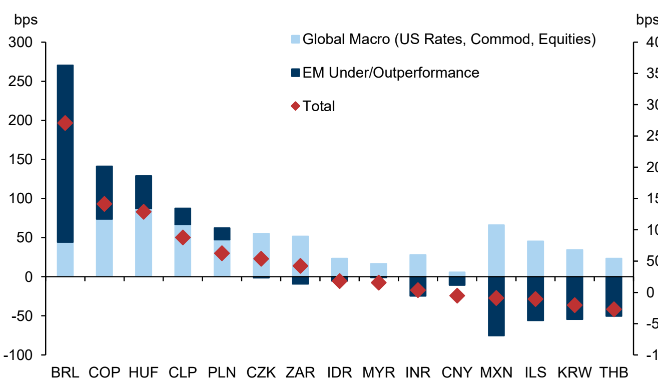
Performance over the past 6 months



Source: Goldman Sachs Global Investment Research, Bloomberg

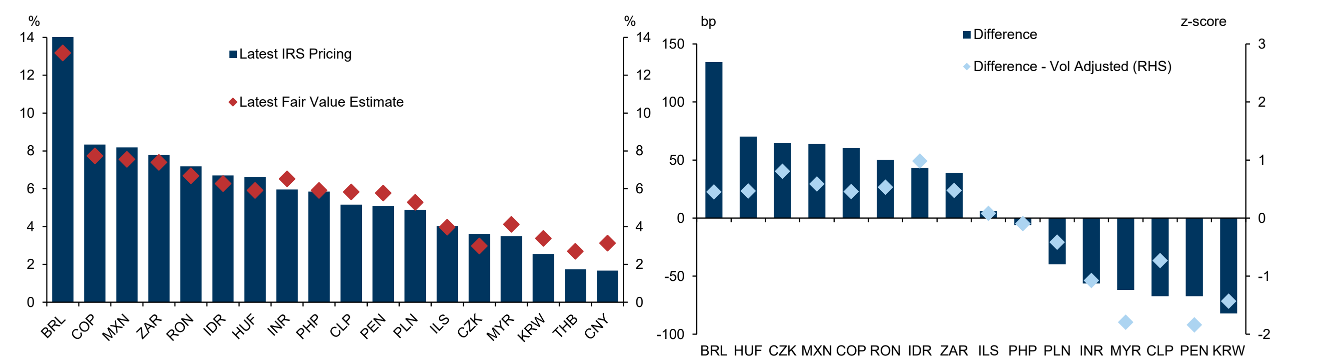
Contribution of local and global shocks to country specific 5Y IRS performance

Performance over the past 6 months



Source: Goldman Sachs Global Investment Research, Bloomberg

Latest 5Y fair value estimate vs. IRS pricing (LHS); valuation gap (RHS)



Source: Goldman Sachs Global Investment Research, Bloomberg

References

- **Term Premium Model:** We apply statistical methods from the group of affine term structure models to dissect rates into a risk-free rate component and a term premium component. "EM Local — Pricing Cyclical Optimism in the Long End", Global Markets Daily, Sep. 27, 2024.
- **EM Local Rates Fair Value Model:** We model a set of curve factors emphasising forward-looking fundamental data and market pricing risks as inputs to produce fair value estimates across the curve. "Searching for (Fair) Value in EM Local Rates", Global Markets Analyst, Feb. 11, 2025.
- **Global vs. EM-Specific Shocks:** We apply a sign restriction approach to identify moves in rates driven by Global factors (US Rates, Equities and Commodities), and EM-specific factors. "Unpacking the Global Factors in EM Local Rates", Global Markets Daily, Mar. 28, 2024."

Disclosure Appendix

Reg AC

We, Tadas Gedminas and Kamakshya Trivedi, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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