Emerging Markets

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Trade of the Year 2026

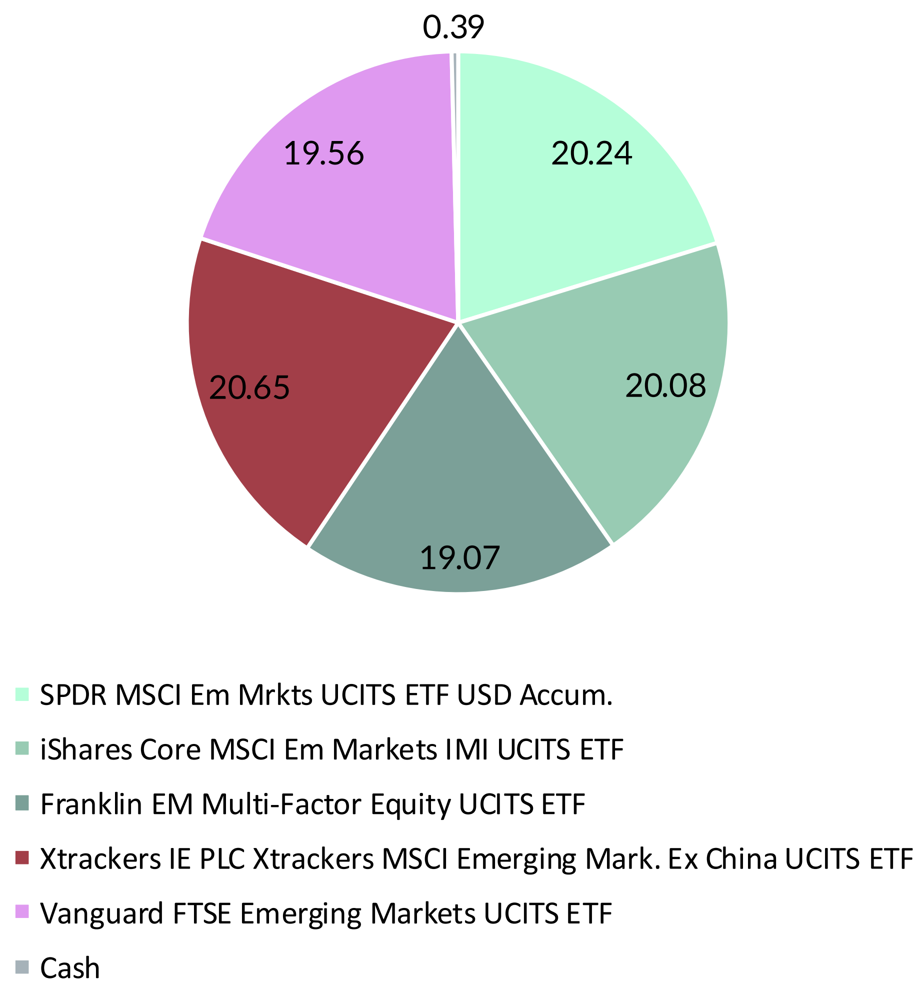
Tactical Diversification into Emerging Market Local Currency Debt

January 12th, 2025

Agenda

1. Portfolio Context
2. Macroeconomic Thesis
3. Trade Rationale
4. Execution and Risk

Our current allocation



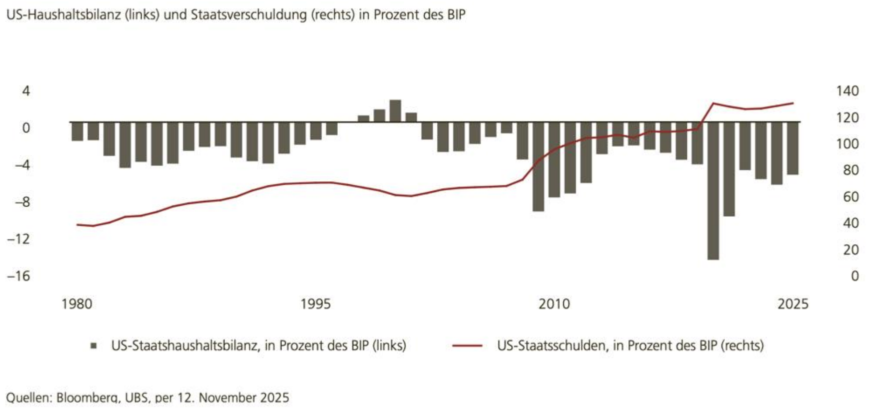
- 100% invested in the benchmark served us well so far with EM stocks strongly outperforming in 2025
- In the current environment, relying solely on equity risk premiums to generate returns might be imprudent
- I recommend a tactical diversification into Emerging Markets (EM) Local Currency Sovereign Debt

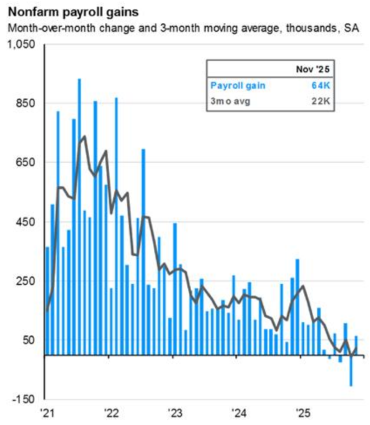
iShares J.P. Morgan EM Local Govt Bond UCITS ETF
IE00BFZPF546

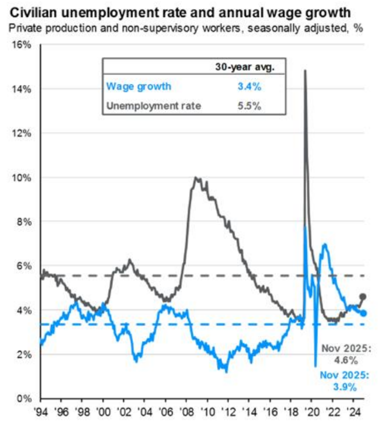
Source: LLB

The end of exceptionalism

- The U.S. cyclical growth advantage is fading - labor markets and consumption cool rapidly, even if headline GDP avoids recession. This economic cooling will force the Fed’s hand into a definitive easing cycle compressing the interest rate differential that previously attracted global capital.
- The structural deterioration of the U.S. balance sheet (Fiscal + Current Account deficits) is becoming a primary concern; without high rates to attract inflows, these deficits require a weaker currency to clear.
- As the incentive for capital inflows evaporates with rate cuts, the dollar is left exposed to its fiscal reality, signaling a structural depreciation







Trade Rationale: Carry & FX

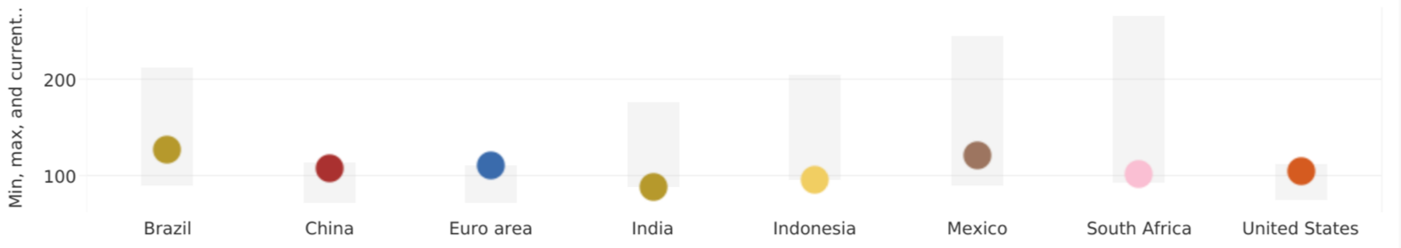
- In this trade, however, we are positioning for two distinct sources of return: High Income (Carry) + Currency Appreciation (FX)
- **The "Carry":** The ETF offers a Yield to Maturity (YTM) of ~6.3%. This acts as a high "hurdle rate," locking in equity-like returns with significantly lower volatility than the stock market.
- **The FX:** By purchasing local currency debt, we are shorting the Euro (and implicitly the USD) against EM currencies. Lower expected rates, the US twin deficit and the European stagnation make EM currencies attractive – raising our return potential

Table 1: **Global Real Yield Landscape 2026**

Country	Nominal Yield (10Y)	Inflation (CPI)	*Real Yield*
Developed Markets			
Japan	2.10%	2.90%	-0.80%
Germany	2.82%	1.80%	+1.02%
United Kingdom	4.41%	3.20%	+1.21%
Canada	3.41%	2.20%	+1.21%
United States	4.19%	2.70%	+1.49%
France	3.52%	0.80%	+2.72%
Emerging Markets			
China	1.88%	0.80%	+1.08%
Indonesia	6.15%	2.92%	**+3.23%**
South Africa	8.39%	3.50%	**+4.89%**
Mexico	8.73%	3.69%	**+5.04%**
India	6.63%	0.71%	**+5.92%**
Brazil	13.69%	4.26%	**+9.43%**

Real Effective Exchange Rates (broad basket) over the past 20 years

Local minimum, maximum, and current values



Source: Trading Economics, Bank of International Settlements, Own Calculations

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Execution and Risks

- Systematically reduce total equity exposure by 10–20% and redeploy proceeds into the iShares J.P. Morgan EM Local Govt Bond UCITS ETF, introducing a second asset class and trying to capture additional risk premiums
- The trade structurally improves diversification – both in asset classes and country specific risks. Unlike the MSCI EM equity index, the GBI-EM index caps single-country exposure at **10%**, reducing idiosyncratic risks while keeping the broader EM growth story intact.
- Three key risks:
  1. **Inflation Resurgence:** If US growth re-accelerates or inflation returns, the Fed must keep rates high. This would reignite the "Strong Dollar" and drain liquidity from Emerging Markets, crushing the trade.
  2. **Tariff Escalation:** If US tariffs sever global supply chains more than expected, the economic damage to export-dependent EM nations could outweigh their yield advantage, triggering currency sell-offs.
  3. **Global "Risk-Off" Shock:** A major geopolitical or financial crisis would trigger a "flight to safety" into the USD. In this scenario, the 6% yield buffer (carry) is insufficient to offset capital losses from a spiking Dollar.