



By: Daniel Lacalle

# 2025 could bring a potential sudden stop to emerging market bonds



In 2020, the FMI recommended global economies spend and borrow and face the consequences later. The pretend-and-extend Keynesian response to the pandemic left persistent inflation and record public debt.

The impact of the misguided recommendation to spend, print money, and bloat GDP at any cost has created a new threat: a sudden stop.

A sudden stop is the abrupt collapse in the flow of capital investment to emerging markets. An important warning sign can be identified in the year-end slump of emerging market currencies vs. the US dollar.

The most financially irresponsible government was Brazil's Lula administration, which **doubled** the fiscal deficit to 9.5% of GDP in the 12 months to October and expects a significant slump in its trade surplus, projected to be between \$70 billion and \$74.6 billion for 2024, down from \$99 billion in 2023. This has made the Brazilian real collapse to an all-time low and close 2024 as the worst major currency against the US dollar.

Other emerging economies have seen a significant decline in the purchasing power of their currency against the US dollar. From China, which finally allowed the yuan to **devalue**, to the Indian rupee, we have seen currency weakness as an indicator of forthcoming credit risk.

Rising yields and currency weakness are two sides of the same coin.

## The strategy of extending and pretending

Many emerging economies fell again into the trap of the US dollar carry trade, expecting elevated liquidity and rising demand for their debt despite the evidence of persistent inflation, US dollar strength, and stretched solvency ratios.

The strategy of extending and pretending was prevalent between 2021 and 2024, despite the

satisfactory performance of global markets. Furthermore, 2024 was a year of **elections** that saw more than seventy governments spending more than ever to please voters and ignoring the risks of the maturity wall arriving in 2025.

The hangover may be coming soon.

## The year 2025 represents a critical juncture for emerging market debt

In 2025, emerging market economies face an enormous challenge due to the rising refinancing requirements, higher rates, and a substantial debt maturity wall. The combination of maturing debt, a weaker Chinese economy, and rising trade tensions heightens the likelihood of a sudden halt in capital flows to emerging markets.

The year 2025 represents a critical juncture for emerging market debt. S&P Global **predicts** that \$80.5 billion in rated debt will mature in 2025. Of this total, \$65 billion is investment-grade debt, primarily concentrated in China and Mexico.

Approximately 81% of rated maturities in emerging markets through 2026 are denominated in U.S. dollars. This means that these issuers will likely face a stronger dollar and higher rates at the time of refinancing.

## Fiscal headwinds

The combination of persistent inflation and slower economic growth in 2025, particularly in Latin America and in China, added to the rising currency depreciation risk and may reduce investor demand.

Furthermore, many of these countries, including Brazil, Colombia, Chile, and India, are betting on high government spending to strengthen growth.

However, this strategy always fails because it ends up creating higher debt, more taxes, and

lower productivity growth. Fiscal headwinds are building rapidly as many countries have taken on more debt since the pandemic, if the model of government deficit spending, higher taxes, and debt refinancing would deliver a stronger economy. It was inevitable that this model would fail, and it did.

### **It is always dangerous to bet on a weaker dollar to disguise fiscal imbalances**

It is always dangerous to bet on a weaker dollar to disguise fiscal imbalances. It is reckless when the policies in the United States are aimed at more tariffs to exporting nations.

The US dollar is strengthening because the currencies of America's trading partners are weakening, and their fiscal challenges are larger.

The combination of a reckless fiscal policy and mounting refinancing requirements means domestic inflation and a more expensive debt service. Add to this the threat of tariffs, and the financial challenge may prove unsurmountable.

## **2025 will be a year of rate cuts**

Many blame the US dollar for the problems of emerging economies. However, those problems are self-inflicted. Those nations that made a massive bet on the US dollar carry trade, increased their fiscal and trade imbalances, and committed to bloating government spending will find themselves as victims of their own leveraged bet against the US currency.

I believe 2025 will be a year of rate cuts and liquidity injections despite persistent inflation. This may not avoid a debt crisis in some major emerging nations, because few governments want to implement supply-side reforms, tax, and spending cuts to strengthen the productive economy.

### **No one trusts a government that has doubled its deficit to cut it to zero in a year of lower growth and elevated debt maturities**

With 81% of maturities in U.S. dollars, a sudden stop could trigger currency crises as countries scramble for dollar liquidity. Many central banks are selling US dollar reserves to stop the bleeding in their currency, which is a dangerous and worthless strategy when fiscal policy remains irresponsible.

The aggressive selling of US dollar reserves seen in some emerging economies like Brazil has not stopped the bleeding of the currency, and, at the same time, investors do not believe the fake promises of "next year" budget balances.

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## **The winners in emerging markets**

According to S&P Global, emerging market debt yields have risen to 10-year highs, and some EM bond experts see this providing a buffer against volatility.

Higher yields mean more risk, not a better opportunity, so investors will be paying more attention to the fiscal situation of each government than to an allegedly attractive yield.



*The winners in emerging markets are likely to be those that implement strong measures to limit deficits and government spending - Daniel Lacalle*

Few bond investors will prefer high-yield emerging debt and currency risk, which could potentially offset any positive returns compared to US 10-year Treasury yields above 4 or 4.5%.

This implies a significant withdrawal of capital from emerging economies, particularly during a year when numerous governments have pledged extravagant spending plans and socialist policies.

Credit upgrades may help some issuers, but we must remember that rating agency actions rarely change a trend of capital outflow when it starts, especially when the rating upgrades come from exceedingly optimistic expectations of growth and tax receipts.

The winners in emerging markets are likely to be those that implement strong measures to limit deficits and government spending, those nations that will cut taxes, attract capital, and return to economic sanity.

The risk of a sudden stop is real; it is not inevitable. Argentina has proven that decisive budget cuts, pro-growth policies, and deregulation work.

Countries that abandon the MMT fantasy of government spending, taxing the private sector, and printing will avoid a sudden stop. Countries that implement policies aimed at strengthening foreign investment, attracting private capital, and reducing the tax burden will win. Those countries that choose to

persist with socialist policies will ultimately face failure. Again.