

FOCAL POINT

EM EUR debt still offering a yield pickup

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Our Focal Point series explores topical issues on macro, markets and investment

- The EM EUR external debt index has underperformed the EM USD debt index on a total return basis year-to-date, due to the sell-off of Bunds in March. However, it has been outperforming on a spread basis.
- At the index level, EM USD external debt is expected to offer a better total return by the end of the year (FX-hedged), but not by a large margin. This outperformance will be driven by lower US Treasury rate expectations.
- It remains that for investors focused on all-in yield, EM EUR debt still offers a yield pickup over EM USD debt after FX hedging. We ran a new in-depth analysis at the country level, covering 410 pairs of bonds (matched by country and issuer, FX-hedged):
 - In the IG space, Romania, Kazakhstan and Mexico (EUR) offer an attractive yield pickup. Romania's EUR debt offers one of the largest yield pickups over its USD debt, but the risk of a downgrade to high yield is a cause for caution.
 - In the HY space, the most attractive are Egypt, Cameroon and Ivory Coast. We still like the medium-term possibility of an IG upgrade for Serbia and Morocco. It should attract EUR crossover inflows, leading to some EUR-USD spread compression.

EM external debt in EUR has been underperforming USD external debt year-to-date on a total return basis but outperformed on a spread basis. Still, some opportunities in the EUR debt space remain. First, we take stock of the recent drivers of this EUR performance. Second, we present the results of our new methodology to track the yield pickup that EUR bonds can offer to investors. We identify the opportunities across the EUR curves vs the USD curves.

EM EUR debt: weak start to the year

Since the beginning of the year, EM EUR external debt has underperformed EM USD external debt on a total return basis. This is an unusual performance, as it marks the worst

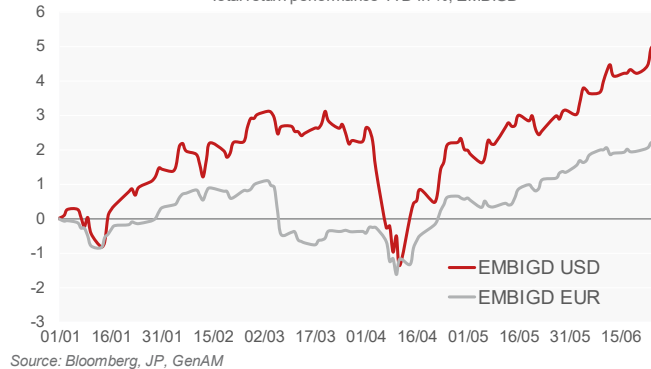


start to the year for EUR debt since 2019 and the fourth worst in the past decade. This consistent underperformance in total return has been observed across all regions and rating buckets throughout the year.

The main driver is the underperformance of core European rates compared to the US Treasury rates, with the transatlantic spread gradually tightening in January and February before reaching a low in early March following the change in the German fiscal stance.

Large USD total return outperformance

Total return performance YTD in %, EMBIGD



The movements in the spread space depict a different situation: EM EUR spread has eventually outperformed EM USD spread, tightening more in relative terms year-to-date. This is because EM EUR spread has benefited from the weakening in US exceptionalism, given that European names represent 60% of the EUR index. However, this spread outperformance is limited and this move has gradually faded. Most of the spread outperformance comes for HY names. We see several reasons for this fading:

- The new German fiscal package has revived some fiscal concerns within the European region, leading to some sell-off of CEE names.
- Large (more than 100 bps) spread widening in Romania which represents 9% of the EUR index versus 2.6% in the USD index.
- The prospect of lower UST rates versus the risk of higher EUR rates could have increased demand for EM USD debt relative to EM EUR debt, which supports some USD spread compression.
- EUR issuance has increased significantly in relative terms to reach 30% of total EM sovereign issuance — the highest level since 2015, weighing on EUR spreads negatively.

EM EUR outperforms in spread terms

USD/EUR spread ratio, EMBIGD



But spread outperformance limited to HY

USD/EUR spread ratio, EMBIGD



EM USD debt to offer better expected return

By the end of this year, the total return prospects for EM USD debt are more attractive. We expect the USD return to be 2.6% (FX-hedged) and 1.8% for EM EUR debt.

Indeed, we see more potential for lower USD rates, with the 10Y Treasury declining to 4.20% by late 2025, while the 10Y Bund rate is expected to be at 2.55%.

Similarly, USD debt offers a more appealing carry of around 6.6% versus 4.2% for EUR debt. This carry provides a buffer in the event of a higher US Treasury rate, given the rising fiscal concerns in the US that could affect the long end of the curve. While we acknowledge that the USD index is more oriented towards high yield, even when considering investment grade names, USD external debt still offers 200 basis points more carry than EUR debt.

The evolution of the spread should not affect meaningfully the return difference. In both the EUR and USD spaces, we expect a modest widening by the end of the year, given the current spread levels' richness. EUR spreads could widen a bit less, benefiting from the attractiveness of European names and the end of US exceptionalism. However, this should not be enough to make a significant difference in return compared with the expected divergent path of core EUR and USD rates.

Better EM USD total return prospectd (FX-hedged)

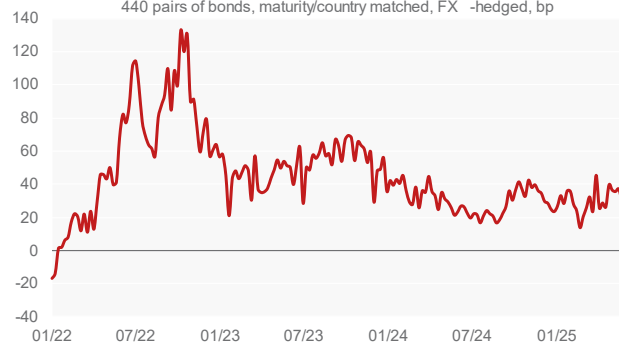
Return until year end for different rate and spread scenarios, Dgov index

OAS spread		US 8Y							
		3.81%	3.91%	4.01%	4.11%	4.21%	4.31%	4.41%	4.51%
current	202	5.91%	5.22%	4.53%	3.84%	3.15%	2.46%	1.77%	1.08%
	207	5.56%	4.87%	4.18%	3.49%	2.80%	2.11%	1.42%	0.73%
	212	5.22%	4.53%	3.84%	3.15%	2.46%	1.77%	1.08%	0.39%
	217	4.87%	4.18%	3.49%	2.80%	2.11%	1.42%	0.73%	0.04%
	222	4.53%	3.84%	3.15%	2.46%	1.77%	1.08%	0.39%	-0.30%
	227	4.18%	3.49%	2.80%	2.11%	1.42%	0.73%	0.04%	-0.65%
	230	3.97%	3.28%	2.59%	1.90%	1.22%	0.53%	-0.16%	-0.85%
	235	3.63%	2.94%	2.25%	1.56%	0.87%	0.18%	-0.51%	-1.20%
	240	3.28%	2.59%	1.90%	1.22%	0.53%	-0.16%	-0.85%	-1.54%
	245	2.94%	2.25%	1.56%	0.87%	0.18%	-0.51%	-1.20%	-1.89%
	250	2.59%	1.90%	1.22%	0.53%	-0.16%	-0.85%	-1.54%	-2.23%

Source: Bloomberg, GenAM calculations

Median yield pickup of EM EUR vs EM USD

440 pairs of bonds, maturity/country matched, FX -hedged, bp



Source: Bloomberg, GenAM

EM EUR return scenario: lower carry and higher duration

7M total return for different scenarios, BofA index

OAS spread		DE 7Y							
		2.03%	2.18%	2.23%	2.28%	2.33%	2.38%	2.43%	2.48%
current	164	5.1%	4.2%	3.9%	3.6%	3.3%	3.0%	2.7%	2.4%
	169	4.8%	3.9%	3.6%	3.3%	3.0%	2.7%	2.4%	2.1%
	174	4.5%	3.6%	3.3%	3.0%	2.7%	2.4%	2.1%	1.8%
	179	4.2%	3.3%	3.0%	2.7%	2.4%	2.1%	1.8%	1.5%
	184	3.9%	3.0%	2.7%	2.4%	2.1%	1.8%	1.5%	1.2%
	189	3.6%	2.7%	2.4%	2.1%	1.8%	1.5%	1.2%	0.9%
	194	3.3%	2.4%	2.1%	1.8%	1.5%	1.2%	0.9%	0.6%
	199	3.0%	2.1%	1.8%	1.5%	1.2%	0.9%	0.6%	0.3%
	204	2.7%	1.8%	1.5%	1.2%	0.9%	0.6%	0.3%	0.0%
	209	2.4%	1.5%	1.2%	0.9%	0.6%	0.3%	0.0%	-0.3%
	214	2.1%	1.2%	0.9%	0.6%	0.3%	0.0%	-0.3%	-0.6%

Source: Bloomberg, GenAM calculations

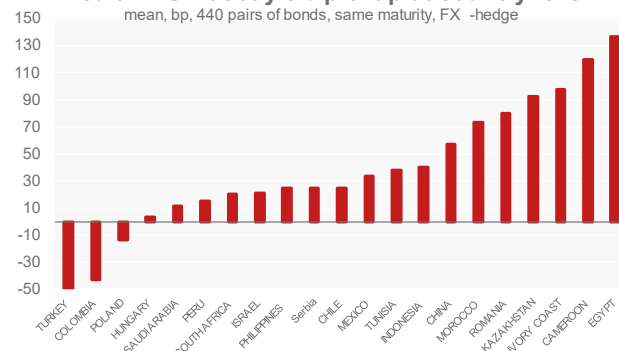
It remains the difference in total return in both indexes is not very large. A small change in core rates direction could provide similar return for EUR and USD external debt. It is difficult for investors to take positions at the global index level and in certain cases, it is more relevant to extent the analysis at the country level and to rather focus on the yield pickup.

EM EUR debt still offer a yield pickup for all-in yield investors

Although the expected return on USD external debt is higher at the global index level, there are still compelling yield opportunities in the EM EUR space. For long-term investors sensitive to all-in yields, numerous EM EUR bonds can offer a higher (FX-hedged) yield than EM USD bonds.

Median EUR debt yield pickup at country level

mean, bp, 440 pairs of bonds, same maturity, FX -hedge



Source: Bloomberg, GenAM

Firstly, we will favour EM EUR IG countries. They offer a yield pickup of 41 bp, whereas for HY countries, it is 100 bp below its long-term average. Given the less liquid nature of these names, idiosyncratic reasons could explain the recent decline.

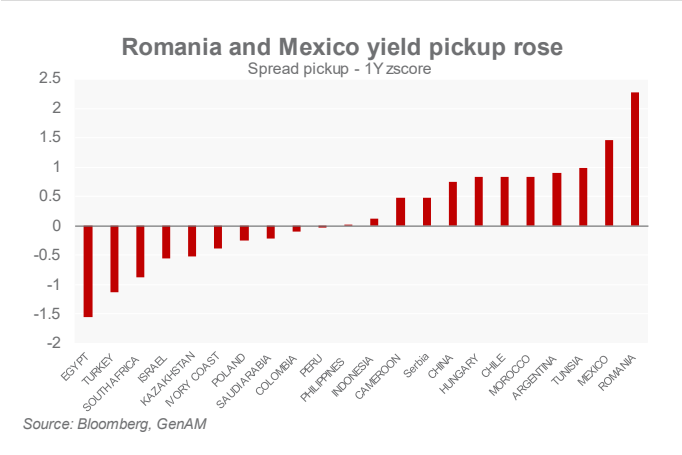
Secondly, Romania continues to stand out by offering a substantial spread pickup on its EUR debt. However, we don't like the name. The large pickup is due to significantly larger EUR issuance and there has been a lack of natural EUR crossover fund buyers of EUR debt, especially at the long end of the curve compared to USD debt. Local Romanian investors tend to focus on the EUR front end, providing an anchor and so the pickup is largest at the back end of the curve.

Romania's spreads have widened significantly, reflecting concerns about fiscal consolidation and the risk of a

downgrade to high yield. In the event of a downgrade, there is a higher risk of forced selling of EUR papers, as they are predominantly held by non-EM dedicated accounts that are more sensitive to credit ratings.

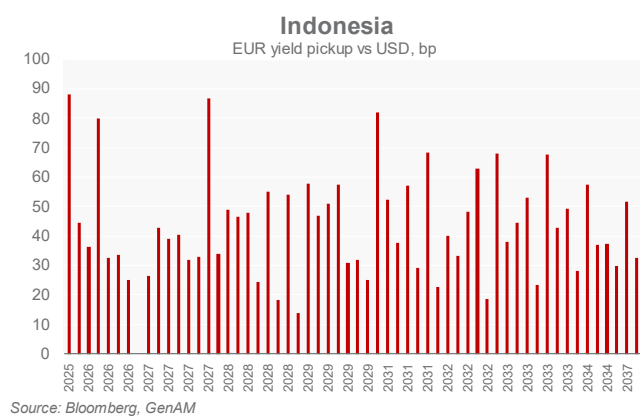
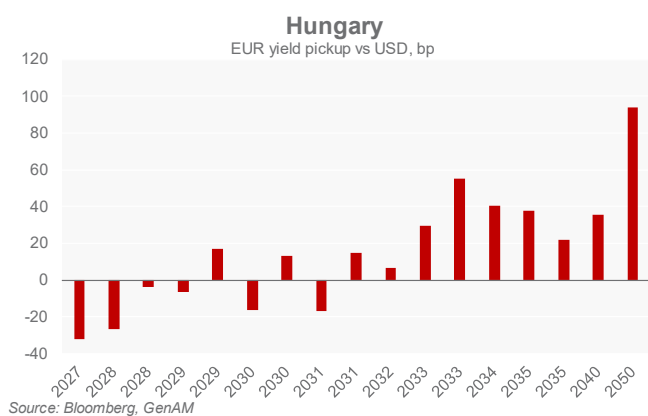
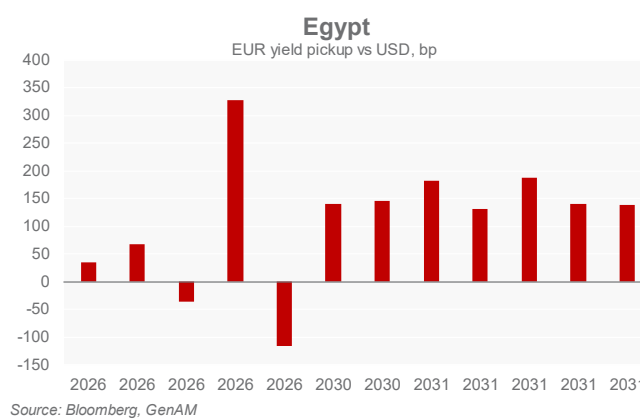
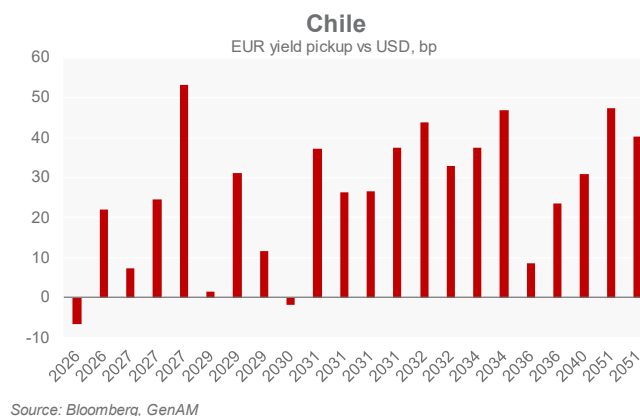
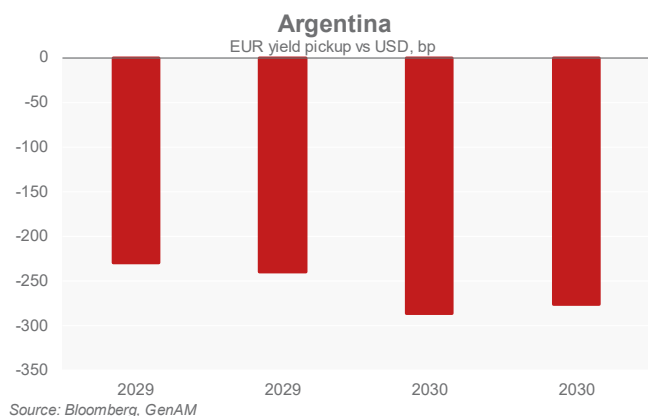
Thirdly, we see value in Mexico EUR spreads. The pickup in Mexico has increased significantly on the back of trade concerns. Fiscal situation should improve and a lot of negativity is already priced in.

Fourthly, we still like Serbia and Morocco's EUR debt given the medium-term prospect of an upgrade to IG. This should attract EUR crossover inflows, leading to compression of the EUR-USD spread.



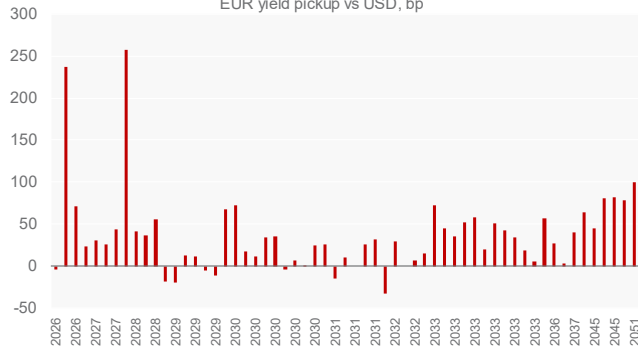
Appendix: Yield differential between EUR and USD bonds, classified by country and maturity.

Below, we show the yield pickup provided by EUR bonds over their equivalent USD bonds for several countries. FX hedging is performed using a cross-currency swap for the remaining bond maturity. A EUR bond may appear multiple times in the comparison with USD bonds, which have a maturity difference of up to 12 months.



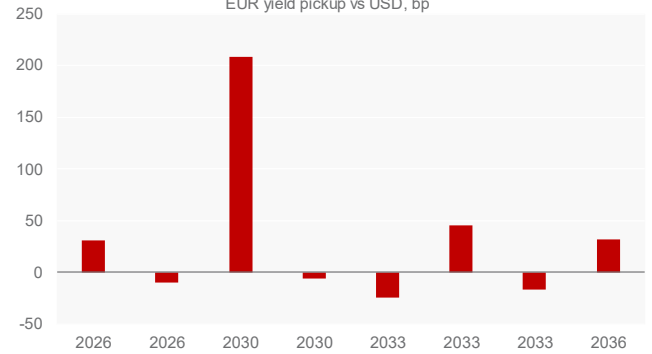
Mexico

EUR yield pickup vs USD, bp



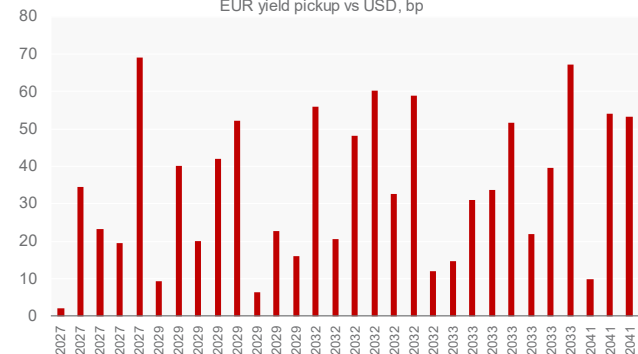
Peru

EUR yield pickup vs USD, bp



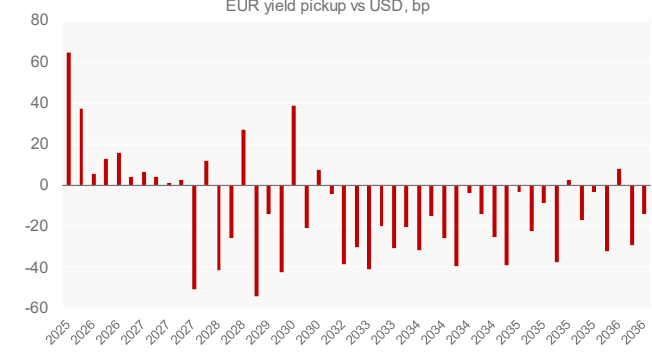
Philippines

EUR yield pickup vs USD, bp



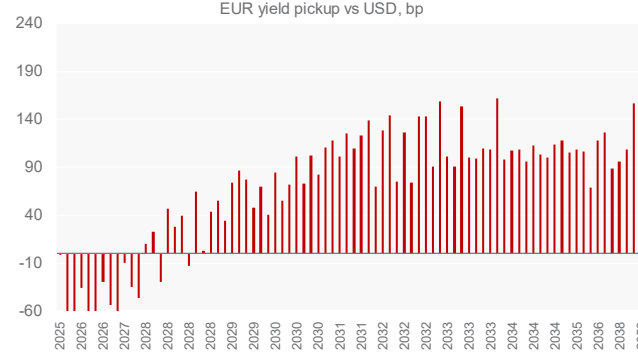
Poland

EUR yield pickup vs USD, bp



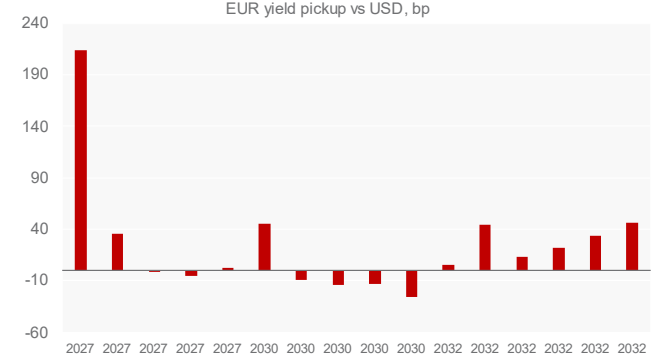
Romania

EUR yield pickup vs USD, bp



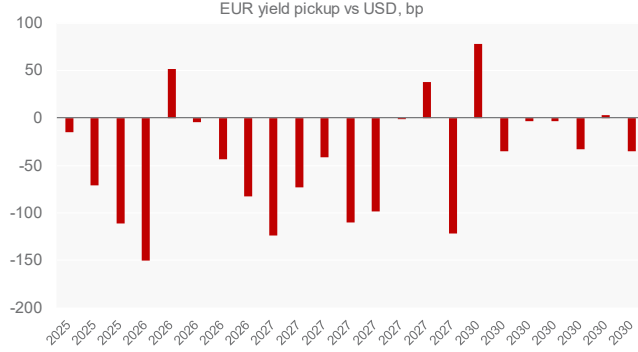
Saudi Arabia

EUR yield pickup vs USD, bp



Turkey

EUR yield pickup vs USD, bp





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