



RBC BlueBay
Asset Management

EM local markets – the next safe haven?

A story of a lower dollar
and China Shock 2.0

For Professional Investors Only | Marketing Communication



Zhenbo Hou
BlueBay Portfolio Manager
Emerging Markets

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**“The stars are
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Developments in the world’s two largest economies – the US and China – continue to keep markets on alert. In particular, the potential of a lower US dollar and the latest ‘China Shock 2.0’ provide interesting opportunities for emerging market (‘EM’) local currency fixed income.

In this piece we argue that both of these trends provide significant tailwinds for the local markets in EM countries, many of which are already demonstrating strong institutional and market discipline.

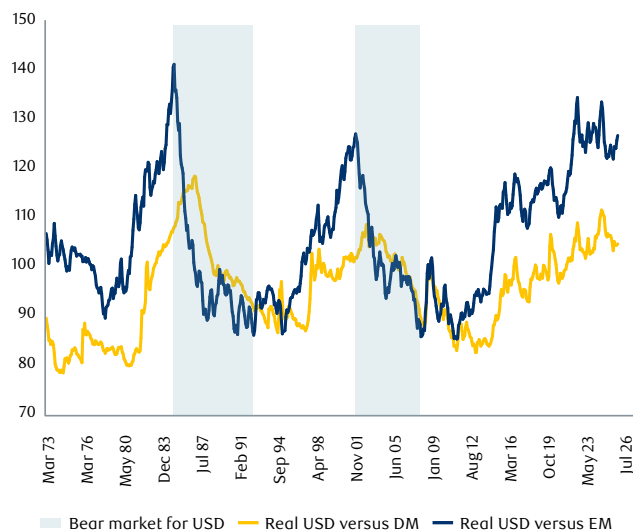
Unlike previous periods, where growth in EM countries was fuelled to a large extent by exports of commodities to China and decades of declining inflation in the US, we now see a shift: China’s impact appears to be contributing to anchoring EM inflation while also becoming a new source of funding, as EM presents an attractive destination for recycling some of its ever-growing current account surplus. This, combined with the investment case we have already been making for the EM local investment opportunity – high EM real rates, fiscal and monetary discipline, a benign dollar backdrop and subdued inflation – means that the stars are aligned for the local market stories in many EM countries to play out in the coming years.

Valuations and structural reasons point to a structurally lower dollar over time

Market excitement for the de-dollarisation thematic can sometimes be difficult to decipher, with much debate around business cycles and structural factors such as debt sustainability in the US and institutional erosion. We take the view that dollar is meaningfully overvalued based on the many metrics including Federal Reserve’s own Trade Weighted Real Broad Dollar Index, which measures the inflation-adjusted value of the dollar against currencies of 26 major trading partners, weighted by how much they trade with the US (Chart 1). The current US administration’s economic statecraft, such as weaponising the dollar for geopolitical gains, erodes the currency’s credibility in the medium term. However, in the absence of a major global disruption, we are sceptical about the demise of the dollar as a global reserve currency anytime soon, given a lack of credible alternatives. Nonetheless history shows that, as the US retreats from globalisation and begins to move away from conventional economic policy norms to prioritise domestic harmony, market forces are likely to hedge their dollar exposure, if not to reduce it outright. Some are seeking alternatives and others are opportunistically avoiding the dollar as the intermediary of exchange by developing bilateral Local Currency Transaction (‘LCT’) schemes.

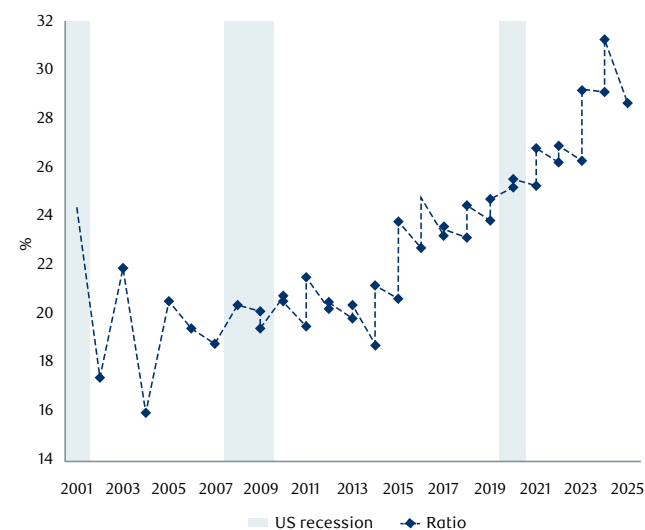
As we have been highlighting, market positioning amongst global investors indicates potential vulnerabilities. Global portfolio exposure to USD-denominated assets remains at historically high levels, despite a slight reduction over the last year following the Liberation Day tariff announcements in April 2025 (Chart 2). More to the point, a significant portion of the exposure is largely unhedged and, following the sell-off in the USD during the April 2025 tariff announcements, global investors are more attuned to this potential vulnerability in their portfolios and have begun seeking alternatives approaches to protect against potential sell-offs in the future, be it hedging or diversification.

Chart 1: The dollar is meaningfully overvalued on a historical basis



Source: JPMorgan, as at 2026.

Chart 2: US assets as a share of global portfolio investment assets



Source: Goldman Sachs, as at 2026.

Reserve currency paradox

Historically, Washington has occasionally resorted to dollar devaluation as a tool to reset domestic social and economic equilibrium during periods when the global reserve currency status became a source of disharmony. This strategy has been especially utile when geopolitical adventures abroad have backfired, diverging social and political objectives at home have run into conflict with each other, or the economy is suffering an unsustainable level of twin deficits. Such an adjustment first appeared in 1933 when President Roosevelt effectively defaulted on federal government and private debt by suspending gold convertibility in 1933 following the Great Depression and devaluing the dollar against gold by 40%¹. Later, in the early 1970s, when the US was mired with twin deficits and internal polarisation over the Great Society program and the Vietnam war, President Nixon moved to leave the Gold Standard altogether in 1971. The dollar depreciated 30% in the next decade (Chart 3).

The most recent example was the *Plaza Accord of September 1985* when finance ministers and central bank governors of US, Japan, West Germany, France and United Kingdom agreed to intervene jointly in

Chart 3: Nixon shock devalued the dollar by 30% from 1971 to 1980



Source: Bloomberg; Data from 1 January 1966 to 29 July 1980.

foreign exchange markets to depreciate the US dollar against the Japanese yen and the Deutsche mark. In the following two years, the dollar depreciated by roughly 50% against the yen and around 40% against the mark. This co-ordinated dollar depreciation was successful in that the US regained export competitiveness and narrowed both trade and fiscal deficits.

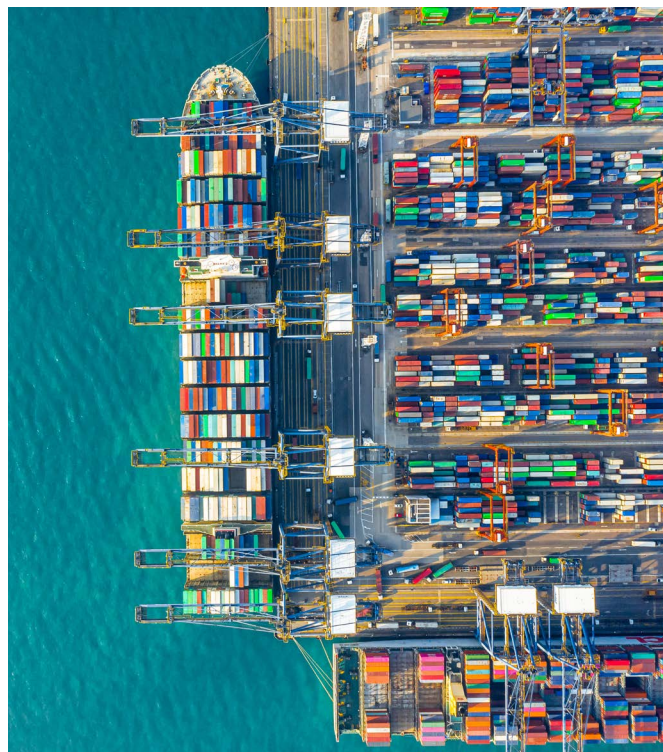
¹ 'Our dollar, your problem: an insider's view of seven turbulent decades of global finance and the road ahead', Kenneth Rogoff, 2024.

As the world's reserve currency, the dollar's role as a geopolitical weapon can be far more potent globally, and the potential unpredictable wielding of such power in a geopolitically fragmented world provides extra incentives for hedging. For example, the US government can freeze sovereign assets held in dollars or US Treasuries as they did with Venezuela, Afghanistan and Russia, potentially crippling a country's monetary system overnight. The dollar can also be used to deliberately influence electoral outcomes – the decision by US government to grant a swap line to Argentina in October 2025 to deliberately swing the mid-term election outcome to Milei's favour underscores the rising risks of politicisation of dollar swap lines². Every time the US weaponises the dollar, it risks eroding its long-unquestioned position as the global dominant reserve currency and potentially motivates rivals and allies alike to seek alternatives for hedging their exposure and reducing their reliance, notwithstanding the high level of dollars many countries have accumulated over the last ten years.

Over time, being the global reserve currency has had its own set of paradoxes for the dollar (see box on previous page). It is tempting to take inspiration from these examples and draw parallels to developments in the US today, where we witness similarly heightened domestic political polarisation and criticism of geopolitical adventures abroad. Stephen Miran, who served as Chair of the Council of Economic Advisers from 2025 to 2026, argued in 2024³ that the dollar's global reserve currency status, along with globalisation, was giving rise to economic and social disharmony, as economic benefits have disproportionately ended up in the hands of those who own financial assets, while the costs were borne by the manufacturing class⁴. This, the argument suggests, ultimately leads to the deindustrialisation of America, as an overvalued dollar erodes export competitiveness but might add to the attractiveness of the reserve asset.

“Every time the US weaponises the dollar, it risks eroding its long-unquestioned position as the global dominant reserve currency.”

Such degradation of the manufacturing base is now deemed by some to pose a national security threat to US military hegemony globally. The Trump administration's policies with respect to rebuilding manufacturing resilience, in theory, run contrary to an overvalued global reserve currency – a role the dollar had taken for granted for decades. How the US manages the policy balance between domestic and international priorities in this populist era will be a critical factor determining the pace of the lower dollar trend for the foreseeable future.



Dollar lacks credible challengers as reserve currency, but the market will keep asking the question

In considering the long-term trajectory of the dollar, one area of focus has been its role as the global reserve currency and whether this dominance is likely to diminish going forward, leading to a fast decline in valuations. In our view, whilst the dominance of the dollar as the key reserve currency could decline, this is likely to occur at a gradual pace. Having said this, even incremental moves combined with alternative trading mechanisms circumventing the need for dollar flows could, on the margin, reinforce the longer-term trend of diversification away from the dollar.

The structural vulnerability of the dollar, such as debt sustainability, is a widely-discussed topic. Lately though, institutional factors, such as questions regarding the Federal Reserve's credibility in maintaining a credible inflation target in the wake of increasing political interference, challenge the long-term outlook for the US treasury market. This comes at a time when some leading economists would argue that decades of ultra-low inflation have created a sense of complacency among US policy elites that lower rates are the norm for the future⁵. Fears of unchecked spending and eroding credibility amongst inflation-targeting central banks in a new era of higher inflation could therefore prompt the rest of the world to seek alternatives. So far, however, the number of viable alternatives remain limited, despite the hype surrounding the renminbi ('RMB') and crypto currencies.

² 'Taking geopolitically motivated US swap lines too far would harm the dollar and Fed independence', Peterson Institute of International Economics, 2026.

^{3,4} A User's Guide to Restructuring the Global Trading System, Miran 2024.

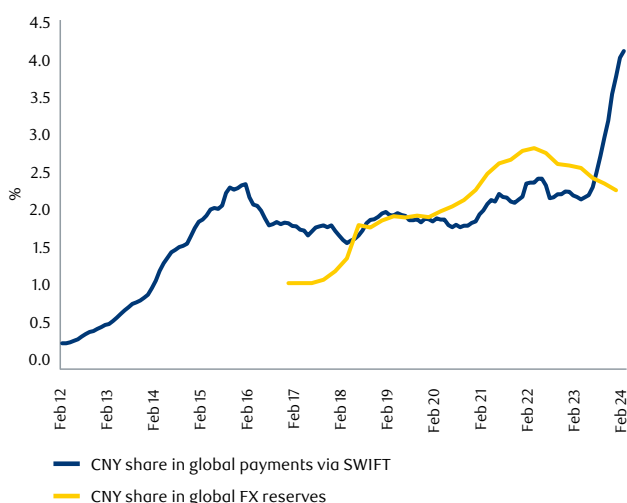
⁵ Rogoff, 2024.

Given the increased role of China in the global trade and financial markets, many have asked whether the RMB is likely to match the role of the dollar as the main currency reference for trade purposes and management of central bank reserves. A truly internationalised currency needs to be a means of payment, a unit of account and store of value⁶. Over the last 15 years the RMB has, indeed, increasingly become relied upon as a means of payment unit – one-third of China’s 6 trillion USD international trade is now denominated in RMB⁷ and the RMB’s share of payments globally has nearly doubled since early 2020, to 3.1%⁸. In trade finance, the RMB’s share globally is now on a par with the euro – rising from 2% in 2022 to 8% in 2026.

“Other traditional, as well as non-traditional rivals might also erode the dollar’s global function gradually over time.”

What is not happening, however, is a broad global shift to RMB-denominated assets as a reserve currency, despite the recent gains (Chart 4). This could be due to a lack of deep financial markets in China and a closed capital account, or simply because the 10-year Chinese government bond yield is heading towards an all-time low of 1.70%, far less attractive than the 10-year US government bond yield that is comfortably in the 5% range, as at September 2026. Nevertheless, when a sovereign entity is considering strategic asset allocation, it would weigh returns against financial security concerns, including uncertainty associated with potential political fallout with Washington.

Chart 4: A gradual increase in CNY’s share in global currencies



Source: SWIFT, IMF, Morgan Stanley Research estimates, as at February 2024.

⁶ Sobel, 2026.

⁷ SAFE, 2025.

⁸ SWIFT, 2026.

⁹ Bank Indonesia, July 2026.



Indeed, the RMB is not the only potential challenger to the dollar. Other traditional, as well as non-traditional rivals might also erode the dollar’s global function gradually over time. For instance, gold preceded the dollar as the global reserve standard during the Gold Standard era and during the Bretton Woods system, when the dollar was pegged to gold until 1971. In fact, gold’s rise in value since 2024 only underscores that it remains a store of value. However, it is difficult to imagine how it could become a credible alternative to the dollar; finite supply makes monetary authorities reluctant to peg their currency to gold as it would mean abandoning the power to adjust monetary policy to domestic cycles. Crypto currency and central bank digital currencies are the latest challengers but so far central bank digital currency initiatives such as Project M-Bridge remain in a nascent stage.

Interestingly, perhaps the most significant initiative that might challenge the dominance of the dollar could be simply electing to skip using it as the intermediating currency. LCTs allow two countries to bypass the dollar as the medium of exchange. This is a proven and viable mechanism for countries to reduce their natural dollar demand in their bilateral trade and investment. One notable recent employment of LCT involves the People’s Bank of China and Bank Indonesia, where LCT transactions accelerated to USD27 billion in just the first five months of 2026 compared to a total of USD13 billion in 2025⁹.

China Shock 2.0 provides new opportunities for EM

The structural headwinds facing the dollar over the medium term suggest a backdrop that is supportive for EM currencies. At the same time, China Shock 2.0 provides a complementary tailwind to EM economies in their current phase of development. During China Shock 1.0, EM currencies and bonds gained across the board over a nearly two-decade property and infrastructure boom in China, resulting in a commodity supercycle that led to rapid improvement in their terms of trade. In addition, China joining the WTO in 2001 helped to anchor inflation in the US by providing access to cheaper consumer products and manufacturing costs. The resulting ultra-low interest rate environment enabled stable financial inflows into EM economies. Such a powerful combination of forces resulted in a ‘goldilocks’ environment that lifted all tides in the EM countries in a rapidly globalising world.

EM can no longer count on low rates in the US. Globalisation peaked around 2016, with the first Trump administration launching its first trade war on China. As US inflation began to become unhinged following the Covid pandemic and Russian invasion of Ukraine, the subsequent hiking cycle by the Fed tightened global financing conditions, including for EM, with little hope for a reversal anytime soon. During the same period, China, as the primary target of US economic coercion, deleveraged its property and infrastructure sectors in order to reduce vulnerability and also decided to compete with the US for technological supremacy. By moving up the value chain of its exports and in search of new markets to avoid tariffs, China began displacing developed economies as a supplier of high-end manufacturing exports to EM countries.

China Shock 2.0 therefore is likely to present an entirely different set of opportunities for EM. Unlike China Shock 1.0, where the commodity boom in the early 2000s and robust domestic China demand lifted all tides in EM, this time China is diverting its high value add exports away from developed markets (‘DM’) destinations to EM.

By raising its global market share in higher-end manufacturing products, it is also anchoring global goods inflation through competitive pricing.

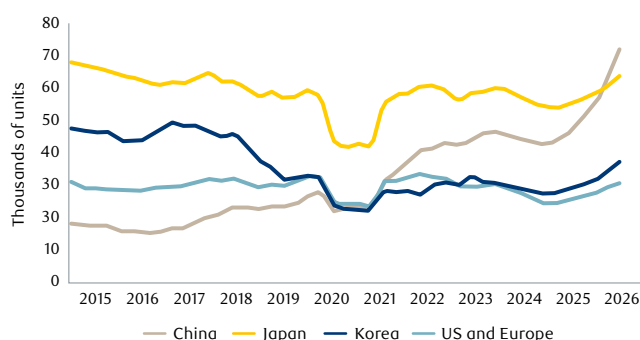
Peru is a striking example. Shipping time from China to Peru’s largest port Callao has halved from 40 to 20 days since 2024. The new Chancay Port aims to reduce shipping time from China to 10 days by 2027. This has led to a larger market share of Chinese consumer goods in general. More recently in China Shock 2.0, we are also witnessing this phenomenon in large ticket consumer items, such as automobiles, where Chinese car makers are winning market share in the country over their DM competitors (Chart 5) because of the competitive nature of their products (Chart 6).

Inflows from Chinese corporates into EM local assets could be meaningful

An even more interesting phenomenon is occurring in the financial accounts between China and other EM markets. As a larger share of corporate profits is earned overseas, the PBOC is no longer seeking to recycle these corporate dollars via reserve accumulations, as its official reserve number has plateaued between USD3 and 3.5 trillion since 2015. Consequently, almost all of China’s current account surpluses are now invested overseas as such surplus is almost matched by its resident non-reserve asset acquisition. The principal agent for recycling China’s record high trade surpluses has now become Chinese commercial banks rather than the central bank. A recent IIF study notes that Chinese banks have tripled their external assets over the last decade to over USD2 trillion¹⁰, which is a historical high (Chart 7).

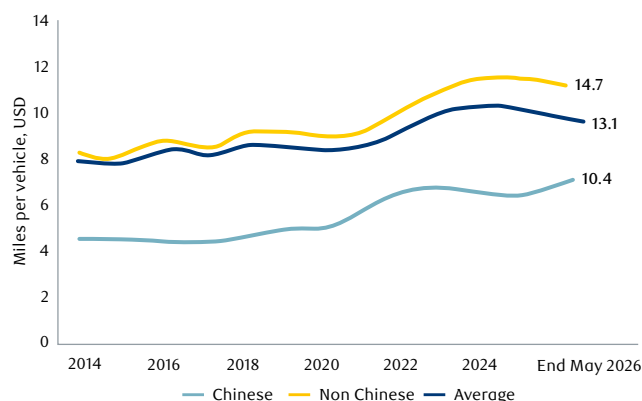
“The principal agent for recycling China’s record high trade surpluses has now become Chinese commercial banks rather than the central bank.”

Chart 5: Chinese car brands lead the Peruvian market for the first time, (four quarter moving average)



Source: BofA, as at August 2026.

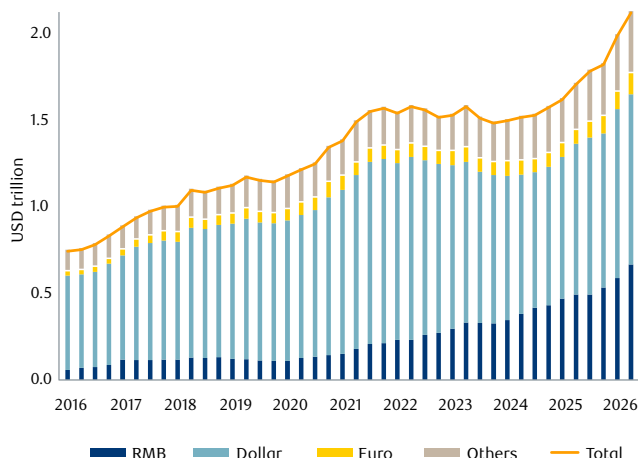
Chart 6: Import price by brand origin



Source: BofA, as at August 2026. Note: excludes luxury vehicles.

¹⁰ How China recycles its record surplus? Institute of International Finance, Gene Ma and Phoebe Feng, 2026.

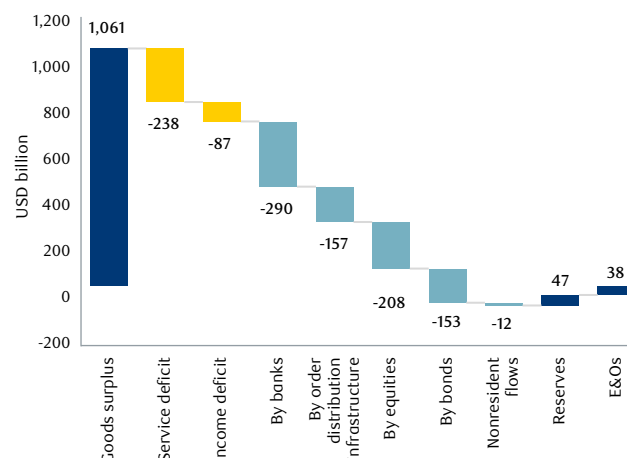
Chart 7: Chinese banks' external assets have tripled in a decade



Source: Haver, IIF.

As these commercial banks become the primary conduit of managing the accumulation of external assets outside the PBOC, it is likely they will be more sensitive to higher real yields available in the EM local currency markets, especially as they provide added diversification benefits. Indeed, our conversations locally suggest these avenues are firmly on their radar. If such shifts in asset allocation happen, it could be significant for the EM local currency asset class. As Chart 8 shows, even an annual 5% of the banks holding USD290 billion share of China's USD1.3 billion annual account surplus recycle this into EM local currency fixed income, it will likely have a meaningful impact on the estimated USD330 billion global dedicated AUM currently tracking the JPM GBI EM local sovereign benchmark, the most widely used benchmark in the asset class¹¹.

Chart 8: Breakdown of Chinese current account surplus in 2025



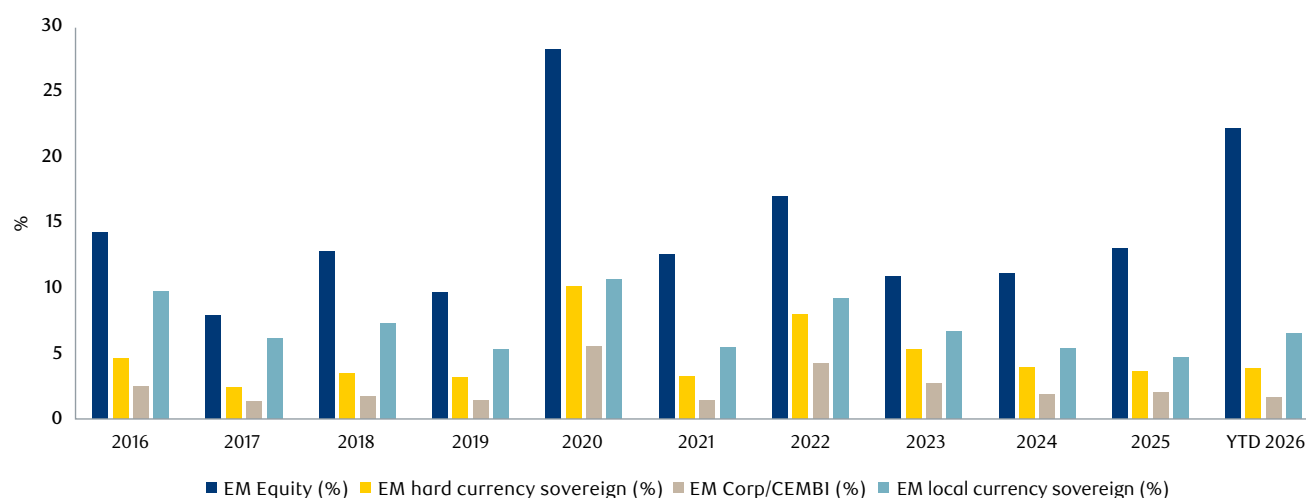
Source: Haver, IIF.

Stars are aligning for EM local markets

We have previously made the investment case for EM local markets based on the combination of high real yields, fiscal discipline and orthodox central bank policies that have anchored inflation and boosted confidence in the institutional framework of these economies. EM has historically benefitted from a lower dollar and that is what we anticipate in the next few years.

Moreover, as volatility of EM local sovereign assets has declined since Covid (Chart 9), the Sharpe ratio for the asset class has also improved significantly.

Chart 9: Volatility of EM local assets has declined since Covid



Source: JPMorgan, as at 2026. For illustrative purposes only. There is no assurance that any of the trends depicted or described herein will continue.

¹¹ JPMorgan, 2026.

We believe the recent trends that are developing in China and US will provide further structural pillars that should support the local EM markets story: the natural need for global market participants to diversify or hedge dollar exposure and US domestic adjustment objectives should provide strong tailwinds to a lowering dollar trend in the medium run. In China, the record high current account surplus is driving interest in EM local currency fixed income as a way to diversify away from the dollar.

At the same time, the inflation anchor provided by China's new export routes to EM and the prospect of new investment patterns within these economies should provide medium- to long-run structural tailwinds for EM local currency fixed income strategies.

Indeed, with these two trends in play, we think many stars will align over the medium term to make the EM market local currency markets a compelling investment story.

EM local markets offer compelling real rates and carry opportunities driven by anchored inflation, orthodox monetary policy, and fiscal discipline

SIX REINFORCING TAILWINDS

1 EM credibility versus DM concerns
Strong EM institutional credibility and economic fundamentals contrast sharply with deteriorating DM debt sustainability and fiscal discipline

2 Dollar downtrend expected
USD overvaluation and technical positioning point to medium-term decline, creating carry-friendly conditions

3 Dollar weaponisation risk
Washington's shifting policy priorities drive diversification away from USD

4 China Shock 2.0
Expanding trade ties and new infrastructure continue to anchor EM inflation

5 Chinese capital flows
Record trade surpluses and tripling of Chinese bank assets abroad signal potential for significant EM investment

6 Lower volatility profile
Sharpe ratios have improved meaningfully in EM local markets, especially versus EM equities

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