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#EMs

/ #Monetary policy /

#Inflation

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EM outlook Q4 2026: weathering the storm

Emerging markets have held up better than expected despite the Middle East conflict, higher energy prices, and rising global bond yields. These dynamics will increasingly test fiscal buffers, prompting some central banks to tighten, but many should still be able to chart their own course.

Key Takeaways

- The resilience of emerging market economies has surprised in the months since the Iran war began.
- Domestic policy responses have partially shielded households and firms from higher prices, but it was strong exports from AI-capex and China's reduction of oil imports that provided most support.
- But, with little sign of an end to the Middle East conflict, a drawn-out period of high energy prices will test fiscal buffers and raise upside inflation risks. China's role as a pressure valve to the global oil market may also weaken, while El Niño may add to food inflation, albeit with a wide range of impacts.
- Despite these pressures, on net, the EM rate cycle should tighten only modestly. The rise in developed market bond yields over Q3 has not triggered disorderly moves for EM bonds or currencies. EM debt dynamics are manageable, with smaller primary balance shortfalls relative to their debt-stabilising levels than many DMs.
- Brazil's October election puts its debt dynamics in the spotlight, but it retains especially high yields and tight monetary policy, while leading candidates should push through modest consolidation.
- The meeting between Presidents Xi and Trump should reduce trade uncertainty, but progress on AI safety is unlikely.

EMs are so far weathering the storm...

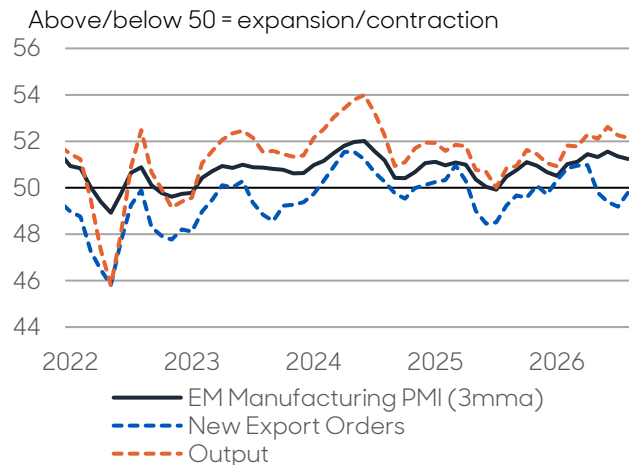
Emerging market (EM) economies have proven resilient amid the backdrop of the Middle East conflict and higher energy prices.

We had previously highlighted how the war's spillover effects would yield varied outcomes, with net energy importers and those Asian economies most dependent on flows transiting through the Strait of Hormuz set to be hardest hit.

Since then, in contrast to the initial energy shock that followed Russia's 2022 invasion of Ukraine, EM manufacturing activity has largely shrugged off spillovers from Iran (see Figure 1). Output has maintained favourable momentum, while export orders have stabilised after an initial dip.



Figure 1: EMs' manufacturing output and demand for their exports have held firm compared to the 2022 shock



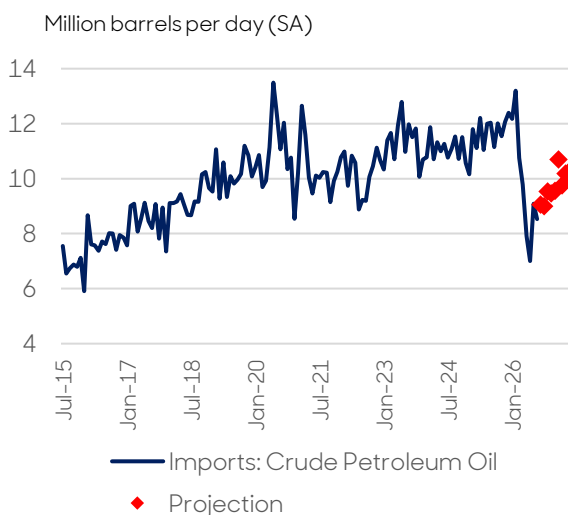
Source: Haver, Aberdeen, September 2026

A combination of factors helped to mitigate the economic fallout of the war. China drawing down its strategic petroleum reserves and flows from the Strait of Hormuz being less constrained than feared helped contain the price shock, while strong demand for AI-related tech products supported global manufacturing.

China's role as a pressure valve may weaken from here. Oil imports picked up to 8.5mn barrels per day in August, and our modelling suggests that the government will want to gradually raise imports over the next six months to around 10mn barrels per day to slow the drawdown of their strategic oil reserves (see Figure 2).

If imports rise as we project, reserves should still be around 450mn barrels above the operational threshold, even if the conflict is unresolved by the end of 2027.

Figure 2: China's ability to act as a pressure valve for the global oil market is time limited



Source: Haver, Aberdeen, September 2026

... but challenges will likely remain

The outlook for the Middle East over the coming six months or more will most likely be characterised by 'sticky' conflict risks. This would be a continuation of the current lack of diplomatic progress between the US and Iran amid the renewed offensive by the Houthis around the Red Sea.

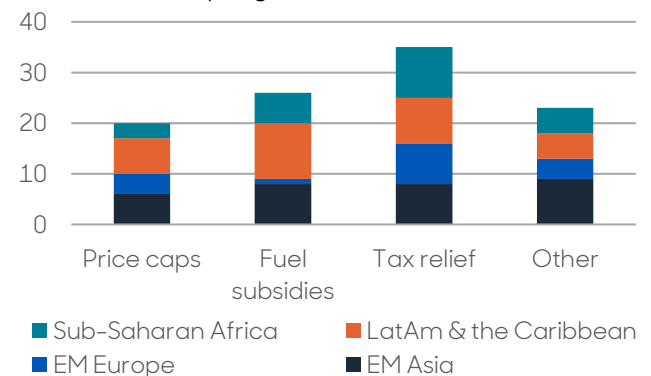
Oil prices within a range of \$80-100 and persistent supply constraints on gas and refined products will make it increasingly difficult for EM governments to shield their economies from the impact.

Policymakers have opted for a mix of price caps, subsidies, and most commonly tax relief as a means of offsetting higher global energy prices (see Figure 3). And thus far, these steps – combined with firms absorbing higher costs into their margins (see Figure 4) – may have helped to blunt the passthrough to output prices.

However, a growing fiscal drag and rising global bond yield pressures make it hard to continue such interventionist measures.

Figure 3: Sticky conflict risks will test EM governments and firms' capacity to mitigate cost pressures

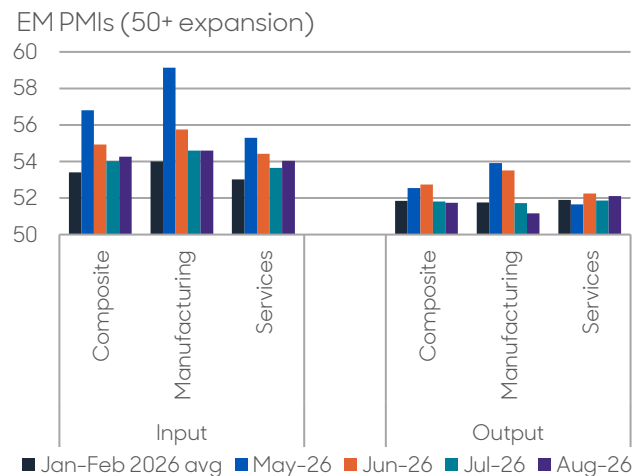
2026 energy shock policy responses, number of countries by region



Source: Aberdeen, IEA, September 2026



Figure 4: PMIs suggest firms have taken much of the hit in their margins, but higher prices may force a rethink



Source: Aberdeen, Haver, September 2026

Central banks should still be able to move at their own pace, helped by reduced FX pressure...

The backdrop of heightened uncertainty in the months since the war between the US and Iran began has seen the broad EM monetary easing cycle stall, with policymakers largely opting either to halt rate cuts, or, in certain cases, to hike to offset price and FX pressures.

Net oil importers' currencies weakened from March to June, but depreciatory pressure has since moderated, with many EM currencies holding up well, and some, like South Korea and Colombia, notably outperforming.

The Colombian peso rallied after (now) President Aberlardo de la Espriella was priced in to win the June presidential race. But the peso's surge in nominal and real terms, alongside lingering fiscal vulnerabilities, leaves it at risk of a reversal.

Meanwhile, the Korean won's Q3 surge follows prior underperformance. The currency had seemingly been weighed down by hedging activity from foreign investors as Korean equities surged. As the equity market cooled, those pressures eased. At the same time, strong economic fundamentals and a more hawkish stance from the Bank of Korea (BoK) helped drive the won higher against the US dollar.

... and scrutiny of DM's bond issuance has not resulted in a synchronised EM selloff

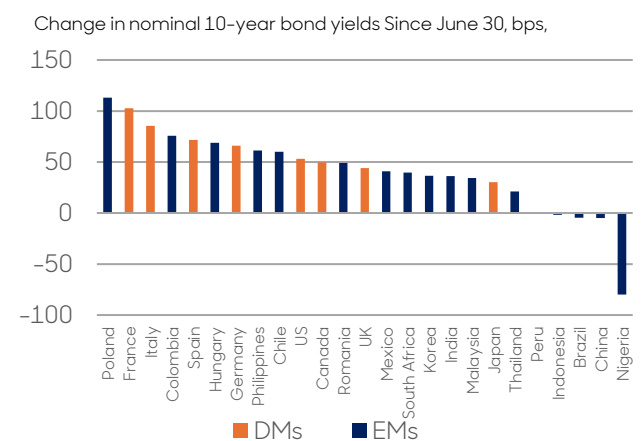
Pressure from the developed market (DM) bond market sell-off has also been taken fairly in stride by most EMs.

Moves at the long end of the curve – at durations that most EMs do not issue – have garnered attention in DM

bond markets. But at the 10-year range, yields have largely risen by a similar or slightly larger degree than the US (see Figure 5).

Poland saw a comparatively sharp selloff amid concerns of further delays in fiscal consolidation, while Nigeria's experienced a nominal yield compression. In Colombia, the notable rise in yields since June marks a partial reversal after de la Espriella's win triggered an initial rally.

Figure 5: EM bonds have not seen disorderly moves



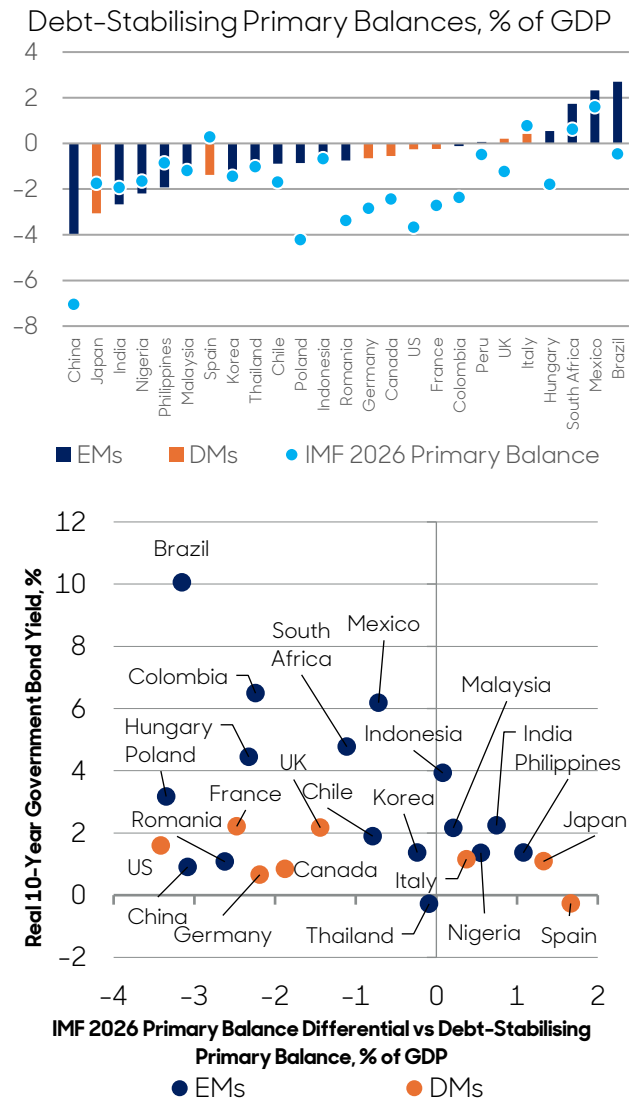
Source: Haver, Aberdeen, September 2026. Note: yields are in local currency terms.

Higher yields of course add an additional challenge for balancing government books but, similar to major DMs, many EM debt trajectories can be stabilised with modest primary deficits.

International Monetary Fund (IMF) projections for 2026 primary balances often signal smaller shortfalls relative to their estimated debt-stabilising levels than most DMs (see Figure 6). Those outliers with greater shortfalls in emerging Europe and Latin America – most notably Brazil, which requires a primary surplus approaching 3% of GDP to rein in its debt – are the ones facing the most investor scrutiny and highest borrowing costs.



Figure 6: Debt dynamics in EMs are not too dissimilar from their developed peers



Source: Haver, IMF, Aberdeen, September 2026. Debt-stabilising primary balances are based on IMF growth and interest rate differentials for 2026-31 in the IMF April 2026 Fiscal Monitor.

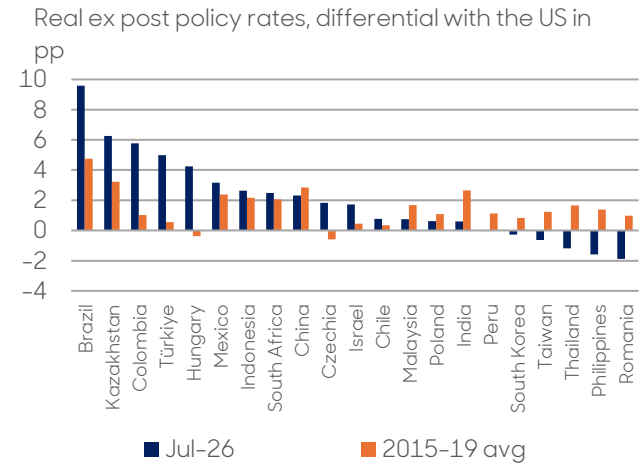
All of this means that neither FX nor debt dynamics need force EMs into hiking, even if delayed inflationary effects and varying regional food supply shocks induced by a historically strong El Niño mean central bankers will navigate differently.

Central banks in EM Asia are most exposed to this confluence of supply shocks, with the Reserve Bank of India (RBI) and Bank Negara Malaysia (BNM) likely to join the hiking cycle before year end.

On the other end of the spectrum in Latin America, Brazil's real rates remain especially high despite 125bps worth of easing since March, which we think will continue

cautiously (see Figure 7). Colombia by contrast began hiking prior to the war due to domestic price concerns, while Mexico will remain on hold to at least mid-2027.

Figure 7: US tightening will add to Asian hawkishness at the margin, while LatAm markets have real rates space



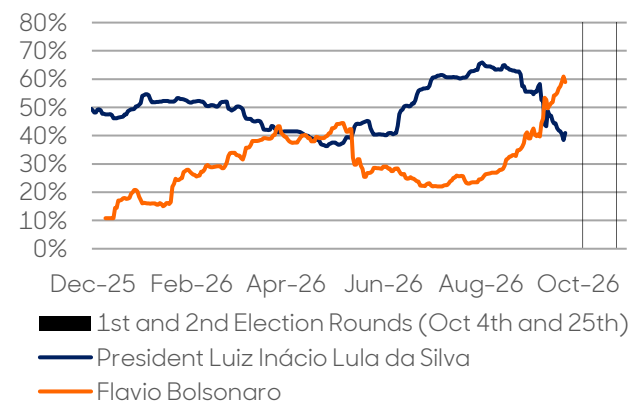
Source: Haver, Aberdeen, September 2026

Brazil's election puts a spotlight on its fiscal and monetary trajectories

Major polls have incumbent President Luiz Inácio Lula da Silva and right-wing opposition candidate Flávio Bolsonaro broadly tied at around 46% each ahead of the first-round of elections on 4 October, well ahead of all other candidates. However, Polymarket now places Bolsonaro's odds of victory at around 57%, up from only 24% at the end of July (see Figure 8).

Figure 8: Bolsonaro's odds have improved, but two-round system and Lula's incumbency make this election hard to call

Polymarket odds for Brazil's October 2026 presidential race



Source: Polymarket, Aberdeen, September 2026



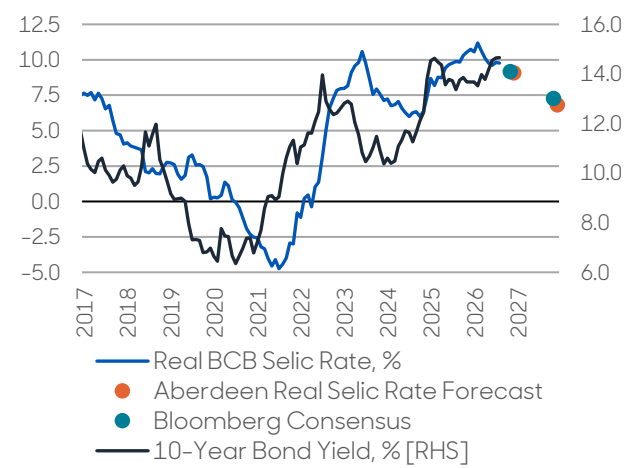
A Bolsonaro win is widely seen by investors as being more conducive to fiscal reform and an eventual fall in yields – and by extension the Banco Central do Brasil’s (BCB) Selic rate – than a Lula re-election.

However, the election remains very polarised, with both frontrunners having high rejection rates among voters, making a firm prediction challenging.

Our current assumption is that incumbency advantage leads to a narrow Lula victory. For instance, recently announced rises in welfare payments could be followed by further populist pledges to bolster electoral support in the coming weeks. But we only put his chances at 55%, and upcoming polls could see a further shift in Bolsonaro’s favour.

Tough market conditions should motivate fiscal consolidation regardless of who wins, facilitating further gradual monetary easing next year. But our own expectations and those of the consensus are for yields and real rates to only moderate gradually over the near term unless consolidation efforts surprise (see Figure 9).

Figure 9: The BCB’s rate path will depend on prospects for post-election yield compression



Source: Haver, Bloomberg, Aberdeen, September 2026

China continues to do its own thing

There is certainly no sign of bond market or debt dynamic concerns infiltrating Chinese markets.

The RMB has continued to strengthen vis-à-vis the USD, while the nominal spread to 10-year yields to USTs has hit a record high (-3.27 percentage points).

China’s relatively lacklustre domestic sector partly explains the gap, and, while demand for tech products is helping offset it, this implies China is at best a weak source of demand for other EMs.

Eventually the authorities will step in with more stimulus, but these dynamics suggest that China’s influence on the rest of the world will primarily be determined by the extent to which it acts as a pressure valve for the global oil market, or whether US-China tensions resurface.

The meeting between Presidents Xi and Trump should at least put the US-China trading relationship onto firmer ground, with some progress in preparatory meetings a positive sign.

We increasingly view technology as the biggest threat to US-China relations. China’s progress in developing near-frontier LLMs (see Figure 10) that threaten US business models and amplify cybersecurity concerns, suggests both sides are on a new collision course.

Figure 10: China’s Kimi K3 model broke into the top 5 LLMs in July, amplifying commercial and cyber-security concerns

Top 5 LLMs based on model performance (judged from reasoning, knowledge, math and coding tests)			
Nationality	Company	LLM	Type
US	Anthropic	Claude Mythos 5	Closed
US	Anthropic	Claude Opus 5	Closed
US	OpenAI	GPT-5.6 Sol	Closed
China	Moonshot	Kimi K3	Open
US	Anthropic	Claude Opus 4.8	Closed

Top 5 LLMs based on usage (weekly tokens)			
Nationality	Company	LLM	Type
China	Tencent	Hy3	Open
China	Xiaomi	MiMo-V2.5	Open
China	DeepSeek	DeepSeek V4	Open
China	MiniMax	MiniMax M3	Open
China	Zhipu AI	GLM 5.2	Open

Source: Aberdeen, Artificial Analysis Intelligence Index, BenchLM.ai LLM Leaderboard, OpenRouter LLM Rankings, September 2026

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