

The Rule of Law in Emerging Markets Debt: A Portfolio Manager's Perspective

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The rule of law has become cornerstone for investors in a global landscape marked by geopolitical tensions, shifting alliances, and debates over international norms. Questions on the rule of law aren't abstract; they're about real-world implications for portfolio construction and client allocations.

In a dialogue with Giulia Pellegrini, we explore why the rule of law has become a driver of alpha in Emerging Market Debt, and why not the current status of a country, but the “trajectory of travel” has become the most critical metric for the modern institutional investor.

The start of 2026 has been marked by a chilling sense of institutional vertigo. From London to Washington, the concept of a stable and predictable international order feels increasingly like a relic of a previous century. We meet with Giulia Pellegrini at a moment when the markets are still digesting the implications of the U.S. administration's unilateral actions in Venezuela. For Pellegrini, an Italian who has made London her home for twenty-five years, these are the raw data of her daily life as a lead portfolio manager in Emerging Market Debt (EMD). Her perspective is shaped by a career that began not in the sterile environments of investment banks, but in the trenches of development economics. From working at the Nigerian Debt Management Office during the transformative Paris Club debt relief era (an informal group of official creditor nations that coordinates to provide debt relief (rescheduling, reduction, or conversion) for developing countries facing payment difficulties, aiming for sustainable debt solution) to stints at the World Bank and eventually the buy-side giants of BlackRock and Allianz GI, she views the global financial map through the lens of institutional evolution. “I thought after doing research and strategy work on African markets, it would be interesting to put those ideas into a portfolio and see how that works out.” Her funds, many classified as Article 8 under the Sustainable Finance Disclosure Regulation (SFDR), incorporate tailored ESG criteria, reflecting client demands for not just financial returns but ethical alignment.

Pellegrini confronts the rule of law's evolving role head-on. “As the rule of law goes, there's certainly more questions than answers at the moment.” The U.S. actions, which involved military posturing and economic pressures, echoed historical precedents like the 1990 Panama invasion under President George H.W. Bush, where U.S. forces ousted Manuel Noriega amid drug trafficking allegations.

Such interventions highlight a pattern of unilateralism that challenges international law, and multilateral frameworks like

the U.N. Charter. For Pellegrini, these events raise questions about international norms: How do they alter perceptions of geopolitical risk? And crucially, for EM investors, how do they reshape capital flows and asset valuations? “On one hand, you've seen the events in Venezuela where the U.S. administration seemingly took action that might be outside the purview of the U.N. Charter and the U.S. Congress,” Yet, this institutional uncertainty has inadvertently created tailwinds for EM debt.



Giulia Pellegrini is a Lead Portfolio Manager for Emerging Markets Debt at AllianzGI, where she focuses on EM sovereign debt strategies and sustainable investing. She is also on the board of the Emerging Markets Investors Alliance.

Prior to joining AllianzGI in 2020, she was Head of Sustainable EM Debt Investing at BlackRock since 2015. Ms Pellegrini was previously Chief Economist for Sub-Saharan Africa in J.P. Morgan's Emerging Market Research team in London and in Johannesburg and an Economist at the World Bank in the Africa Finance and Private Sector Development Department in Washington D.C. She started her career as an Economist at the Debt Management Office of the Federal Republic of Nigeria in Abuja.

Giulia holds master degrees in Development Economics and in Econometrics from the University of Oxford, St Antony's College and from Birkbeck College as well as a BSc in Economics from the School of Oriental and African Studies – University of London.

In a world of heightened geopolitical fragmentation, marked by trade wars, tariff escalations, and alliance realignments, investors are seeking diversification beyond U.S.-centric assets, which dominate 80-90% of global publicly traded equities and bonds. “What we have seen in the last year is more appetite for diversification, and that has certainly benefited EM debt,” Pellegrini explains. The asset class, sidelined post-2022 Ukraine invasion due to sanction fears and defaults, suffered over \$120 billion in outflows through early 2025. But as EM nations demonstrated resilience – taming inflation faster than developed peers and embarking on fiscal consolidation – inflows rebounded. Since April 2025, \$25 to \$30 billion has flowed back, a reversal from a low base but indicative of shifting sentiment. This influx aligns with broader risk signals: gold prices, a barometer of uncertainty, have surged, extending to silver and industrial metals as investors hedge against eroding rule of law perceptions.

Pellegrini’s optimism is tempered by risks. “As political fragmentation continues, and we think it will, the question is, does this ever at some point impact negatively risk appetite in the markets?” she posits. If global events tip into full risk-off mode, EM, historically viewed as “riskier”, could suffer outflows. However, the asset class’s maturation mitigates this: improved policy credibility and economic fundamentals have decoupled EM from blanket sell-offs. “Emerging markets have done a lot of work in terms of improving economic fundamentals, improving policy credibility,” she emphasizes, citing proactive central banking that peaked inflation early and set fiscal trajectories straight in countries from Mexico to Pakistan.

THE RULE OF LAW IS WOVEN INTO EVERY DECISION IN THE INVESTMENT PROCESS

Central to her approach is an investment process where rule of law and ESG are woven into every decision, driving alpha by anticipating credit events. This integration predates regulatory mandates like SFDR Articles 6-9, born from a conviction that governance insights enhance returns. “Our investment process integrates ESG considerations along the value chain,” Pellegrini says. “We’ve been doing this for years before regulations kicked off.” The framework evaluates countries and corporates across environmental, social, and governance pillars, with governance, including rule of law, as the cornerstone. Indicators span property rights (measuring legal protections for assets), corruption perceptions (via indices like Transparency International’s CPI), state fragility (assessing conflict risks and institutional resilience), and press freedom (gauging information transparency and accountability).

For Pellegrini, rule of law is pragmatic: “When we look at rule of law, we think of it as: does this make a country more or less capable and more or less willing to pay us back?” According to Pellegrini, capability ties to economic strength, fiscal buffers,

reserve levels and strong institutions that enable efficient tax collection and policy execution. Willingness reflects political commitment, which may be eroded by corruption or judicial capture.

ESG integration has proven its worth: “Introducing ESG considerations as part of the investment process has helped us, for example, avoid some of the defaults,” she notes, citing zero exposure to Russia, Belarus, Ghana, and Sri Lanka. By flagging governance deteriorations early, the team reallocates to improvers, capturing spread compression as markets reward progress: not as virtue signalling, but as fiduciary duty. “We include all of these considerations because they help us do our work of being fiduciary to our clients,” Pellegrini stresses, emphasizing alpha delivery over moralizing.

WE SEE MORE APPETITE FOR DIVERSIFICATION

While governance dominates in EM, all pillars matter. “We look at all three pillars with equal importance,” she clarifies. Social factors, like labour rights, can trigger litigation impacting corporate bonds; environmental risks, such as disaster vulnerability, strain sovereign finances. A solid governance base amplifies these: transparent institutions better manage social unrest or climate events, reducing default probabilities. For specialized mandates, managing green-social-sustainable (GSS) bonds for banks or CO₂-tracking portfolios, ESG is explicit. “It is investment analysis, not just looking at CO₂ reductions or whether they filed the right reporting.”

The “trajectory of travel” thesis leverages this ESG lens for alpha. “What matters for us in the end is not so much where the country starts off, but the trajectory of travel of that country,” Pellegrini explains. This allows contrarian bets on reformers, as improving rule-of-law metrics signal upside.

The case of Brazil is an interesting one. “Inflation spiked after Covid, but the central bank acted very proactively, building a 10-percentage-point real rates cushion. Unheard of in most markets,” she details. ESG indicators played a pivotal role: rising scores in judicial independence (via World Justice Project metrics) and anti-corruption efforts (post-Lava Jato reforms) enhanced perceptions of willingness. This credibility drew inflows to the real and local bonds, generating alpha as policy rates are expected to fall in 2026 to support growth.

Argentina’s reform path is a deeper dive into trajectory-driven alpha. Historically the country has been default-prone which happened nine times since its independence. The country hit rock bottom in the early 2020s with hyperinflation and depleted reserves. Since 2023, the administration has slashed spending, tamed prices from 200%+ to single digits, and adopted a flexible

exchange rate to rebuild buffers. “Argentina has been doing reforms that have undoubtedly made an impact on the population. But for the last two years, the government has been working towards fiscal consolidation, reducing inflation, starting now to accumulate reserves,” Pellegrini recounts. Rule of law improvements bolstered ESG scores, signalling repayment commitment. Despite social costs (poverty spikes, protests), this trajectory compressed spreads from 2000+ basis points to under 1000, delivering double-digit returns for holders. Investors profited, as markets priced in the shift from populism to orthodoxy.

Nigeria’s story resonates personally for Pellegrini. From her Debt Management Office days, she knew its institutional pitfalls: oil dependence, corruption, and outflows of talent. “Nigeria, where you have a government that since June 2023 has taken over, has done more reforms in two years than the previous 10 combined,” she says. Key moves undertaken by the Nigerian government have been exchange rate liberalization (ending multiple windows that bred arbitrage), reserve accumulation to \$30 billion+, and Nigerian National Petroleum Corporation (NNPC) transparency (board overhaul, audits exposing past mismanagement). ESG metrics captured this as state fragility indices improved (via Fund for Peace rankings), corruption perceptions rose modestly, and press freedom gains reflected accountability.

ESG ANALYSIS IN EMD IS MORE ABOUT ALPHA DELIVERY THAN VIRTUE SIGNALLING

Pakistan is another affirmative case. “A fragile state with nuclear tensions, political instability (a jailed former PM), and IMF bailouts, it nonetheless consolidated fiscally and works with the IMF on reforms,” Pellegrini notes. Governance strides, such as better property rights via land digitization and anti-corruption drives, elevated ESG profiles, enhancing willingness. From a low base, this progress spurred spread compression, with bonds rallying 15-20% in 2025. An uplift in the rule of law converts to tangible alpha.

Conversely, deteriorations demand avoidance. Bolivia exemplifies backsliding. “Bolivia has a maturity coming up in a couple of months, a new government since November and low import coverage of its external reserves,” she warns.

Senegal’s case is similarly cautionary. Prolonged IMF talks, lasting over a year, signal policy inertia. “Senegal has been discussing with the IMF for a support programme. Now they’ve been doing so for a fairly good time, I would say over a year,” Pellegrini says. Rule of law metrics deteriorated: press freedom slipped amid crackdowns, corruption indices stagnated, and fragility rose with electoral disputes. This trajectory forecasts default risks and prompted Pellegrini to withhold investment.

In Asia, Indonesia’s governance lapses illustrate opportunity costs. Protests and a finance minister replacement disrupted stability. “Indonesia, we must say we got concerned with the protests that we saw last year and the change in finance minister that for years had worked as a sort of anchor to the Indonesian investment thesis,” she explains. The prior minister’s World Bank credentials bolstered international trust; the successor’s views and scandals such as corruption in state firms like Pertamina, impacted ESG credential.

China’s stasis is a deeper institutional quagmire. Stabilization signals in December 2025 data clashed with leadership’s tech focus over stimulus. “In China, we see some signs of stabilisation from the data we had in December. However, it is fair to say that the leadership still seems most concerned with getting the country to sort of dominate from a technological standpoint,” Pellegrini observes. Rule of law issues such as arbitrary property seizures, state fragility in Hong Kong tensions cap ESG scores. Deflation risks persisted, with bonds underperforming 5-10%, validating an underweight.

India’s 2025 downturn underscores ESG’s predictive power. Index inclusion in 2024 drove inflows, but policy opacity followed. “The previous governor was very clear on their exchange rate policy. The current governor has been a bit more, let’s say, reserved about giving out clear signals,” she details. U.S. tariffs and Pakistan flare-ups compounded. Governance metrics – fluctuating press freedom, corruption amid elections – signalled reversal. The team acted accordingly, locking 8-12% gains before 10% losses.

The Russia-Belarus divestment in 2021 is ESG’s crowning achievement. Macro appeal (reserves exceeding debt, a technocratic central bank) masked severely weakening institutions. “Our analysis was mostly on the ESG and political side,” Pellegrini recalls. The rule of law plunged due to judicial capture, press suppression, and fragility from authoritarianism. Divestment dodged sanctions, while peers lost 50-100%. “We judged that Russian institutions had been captured more and more over the years and that rule of law had been declining,” she says, turning avoidance into alpha.

Currency dynamics amplify ESG plays. Dollar depreciation in 2025 fuelled EMFX gains. “It does help to have a weaker dollar,” Pellegrini affirms. Structural shifts such as gold diversification favor EM long-term. Valuations are secondary; technicals like index flows matter, but trajectory dominates.

Active trumps passive in EM’s complexity. “EM is probably one of the asset classes where it’s hardest to do passive,” she argues, given 80 countries and fragmentation.

Pellegrini concludes bullishly: EM’s fundamentals, 3.5% deficits, 60% debt-to-GDP, outshine DM. “I have a much more mature EM asset class that offers me 80-odd countries to choose from,” she says.

Rule of law via ESG unlocks alpha in chaos.