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Inflation eases, albeit gradually

Central banks remain stressed by persistent inflationary pressures and the risks of a hard landing for economic activity.

Highlights

- **Early intervention by financial authorities in major economies contained volatility, but risks remain.** Financial conditions remain tight, and a recession in advanced countries is possible. Nevertheless, persistent inflation has led central banks to maintain a cautious approach to monetary policy.

- **International financial asset prices recover after the turmoil generated by the collapse of some banks.** In recent weeks, stock indices have risen across the board (MSCI World: +4%), commodity prices have rebounded, and the global dollar has depreciated. Long rates partially recover their initial decline.

- **Local activity in February shows that the economy is stalling.** For March, we estimate a slight monthly decline, but more demanding bases of comparison will lead to an annual fall of 1.2%. We maintain the projection of a GDP change of -0.25% in 2023, somewhat below the mid-point of the last Monetary Policy Report (IPoM) projection (0%).

- **Employment continued to grow in February, although it remains well below historical levels.** The labour force also increased, raising the unemployment rate to 8.4%. Slow labour recruitment due to weak labour demand and a labour supply that will continue to expand in line with its trend will push unemployment up in the coming months.

- **The March CPI (1.1%) aligned with expectations and marked a further decline in its year-on-year change.** The indexation of educational services influenced the month's figure. The non-volatile CPI, excluding education, was substantially lower and confirmed a moderation in inflationary pressures. We estimate that the annual change in the CPI will close the year at around 4.7%.

- **Unsurprisingly, the Central Bank kept the MPR at 11.25% at its April meeting.** In the IPoM, which accompanied the Monetary Policy Meeting, both activity and inflation projections were raised, and the rate corridor was adjusted upwards, delaying the first rate cut to September 2023. Nevertheless, we believe that by the July meeting, the conditions will be in place to initiate rate cuts, which could bring the MPR down to 7.75% by the end of the year.

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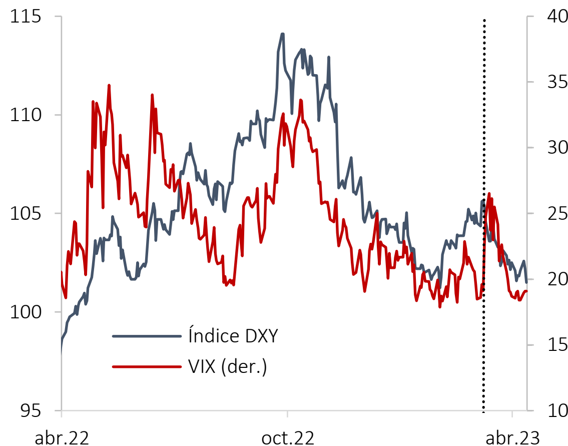
Persistent core inflation complicates monetary policy decisions in major markets

The financial turmoil generated weeks ago by the situation of some banking institutions in the US and Europe has tended to dissipate, reducing volatility in the markets (VIX: -3 points). Nevertheless, risks remain as financial conditions stay tight and significant levels of uncertainty remain.

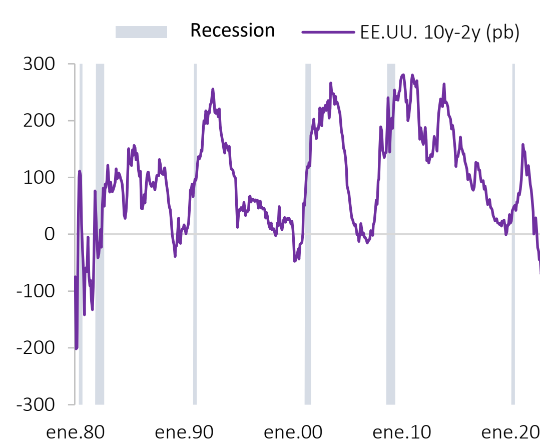
Beyond that, the main concern for monetary authorities is the persistence of core inflation in the major economies. While traditional measures of inflation have declined due to year-on-year declines in oil and food prices, excluding volatile prices still shows no moderation and, in some cases, even an acceleration. This has led various monetary authorities to argue for the need to maintain tight monetary conditions for an extended period. Similarly, in its recent World Economic Outlook (WEO), the International Monetary Fund noted that this phenomenon requires that monetary policy focus on lowering prices as financial risks dissipate.

The global risk of a deep financial crisis recedes, and volatility moderates



Source: Bloomberg and Santander

However, recessionary fears remain latent, especially in the US



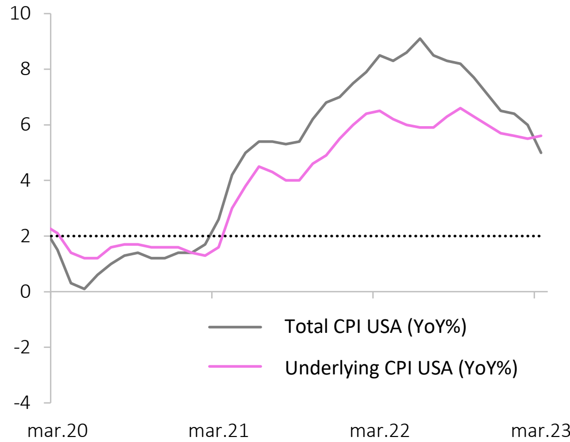
Source: Bloomberg and Santander

In the US, the March CPI, although somewhat lower than expected (0.1% MoM vs 0.2% expected) – which has driven the YoY change down for the ninth consecutive month to levels close to 5% (from a peak of 9.1% YoY last June) – showed that underlying components continue to exert pressure (core CPI: 0.4% MoM vs 0.4% expected), particularly services prices. This, coupled with a persistently strong labour market and reduced concerns about the financial situation of banks, has led bets to lean again towards a further increase (+25 bps) in the benchmark rate at the next Federal Reserve (Fed) meeting on May 2 and 3.

Nevertheless, markets are still betting that in the second part of the year, the Fed will be forced to cut its rate due to the growing possibility of a hard landing of its economy. The latest economic indicators point to a loss of momentum (composite PMI: 52.3 vs 53.3 expected; industrial orders: -0.7% vs -0.5% previously), and the spread between long and short rates continues to point to a recession (spread between 10 and 2-year rates widened by almost -60 basis points). The labour market, while still robust (unemployment rate: 3.5% vs 3.6% expected; non-farm payroll job creation:

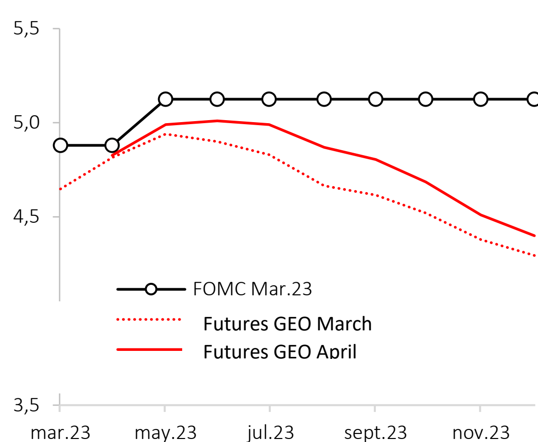
236,000 vs 230,000 expected), has shown some data that could signal some deterioration from now on (new job openings reached MCh$ 9.9 at the end of February, below the MCh$ 10.5 expected; initial jobless claims: 228,000 vs 200,000 expected).

Total inflation continues to decelerate, while core inflation still shows persistence



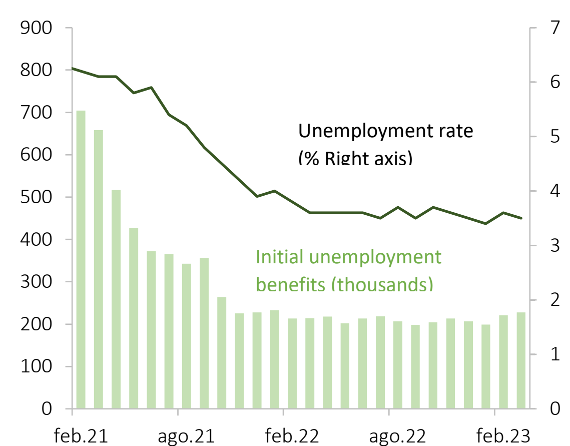
Source: Bloomberg and Santander

After March CPI figures in the US, another MPR hike is expected in May



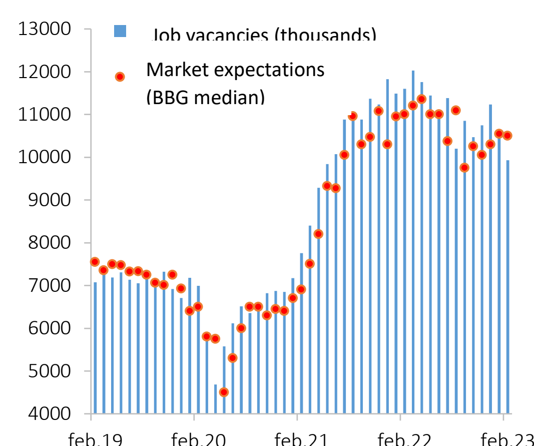
Source: Bloomberg and Santander

US labour market still resilient in March



Source: Bloomberg and Santander

Job vacancies in the US decline

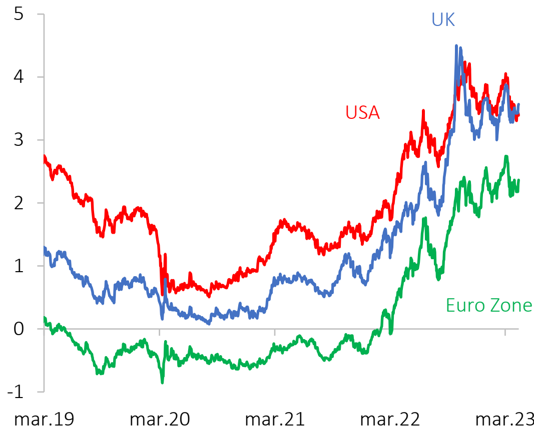


Source: Bloomberg, Bureau of Labour Statistics y Santander

Against this background, international stock market indices advanced across the board in the month (MSCI World and emerging market indices: +4%; MSCI Latam: +8%; US: +4%; Eurozone: +3%; China: +2%): +4%; MSCI Latam: +8%; US: +4%; Eurozone: +3%; China: +2%) and 10-year Treasury yields which had fallen in advanced economies, tended to recover partially, with the US10Y at a similar level to a month ago (around 3.4%). In addition, commodity prices rebounded (aggregate index: +7%), with energy commodities leading the gains (+10%) following OPEC's surprise announcement to cut oil

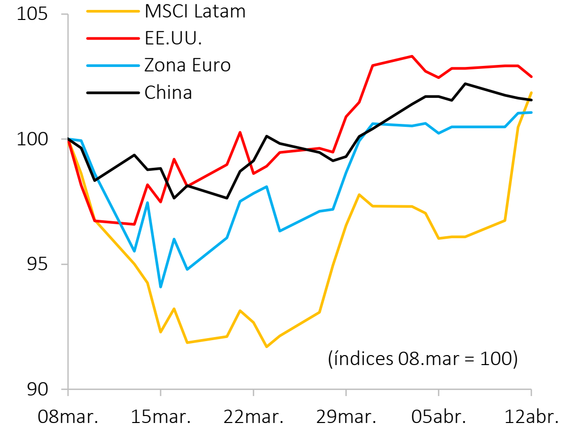
production by MCh$ 1.2 barrels per day starting in May. Meanwhile, metal commodity prices have remained relatively stable.

After a period of high uncertainty, US10Y returns to levels around 3.4%



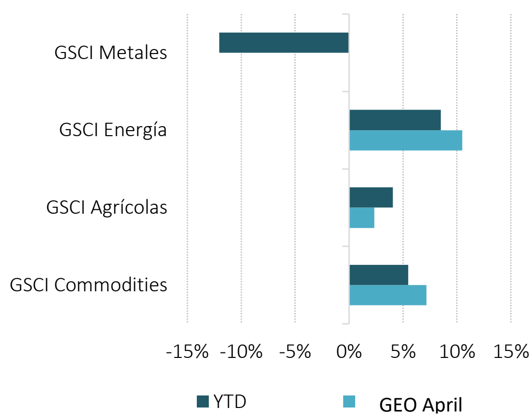
Source: Bloomberg and Santander

International stock indices rally across the board during the month



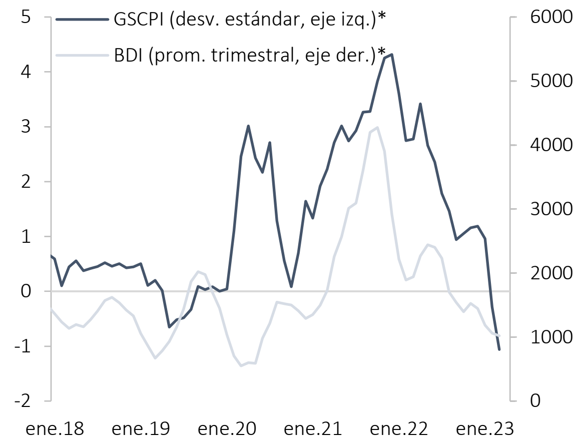
Source: Bloomberg and Santander

Commodity prices rise, driven by energy commodities, except metals



Source: Bloomberg and Santander

Recent measures suggest that conditions in the supply chain have normalised



(*) GSCPI: *Global Supply Chain Pressure Index*. BDI: *Baltic Dry Index*
Source: Bloomberg, New York Fed and Santander

This week, the IMF presented its projection update, where it revised down slightly its global growth estimate for 2023 from 2.9% to 2.8% (3.4% in 2022), anticipating a modest increase to 3% in 2024. The slowdown would be especially led by advanced economies, which would grow by 1.3% this year (2.7% in 2022). The main reasons for the adjustment include (i) tight monetary policies to reduce inflation, (ii) the consequences of the recent deterioration in financial conditions, (iii) the extension of the war in Ukraine and (iv) increasing geo-economic fragmentation. Thus, the risk balance remains skewed to the downside, as they note that the chances of a hard landing have increased considerably and that, in an alternative scenario with higher financial stress, global growth would slow to 2.5% in 2023.

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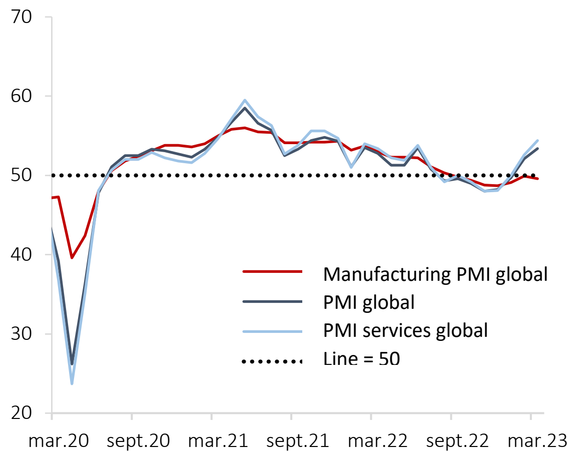
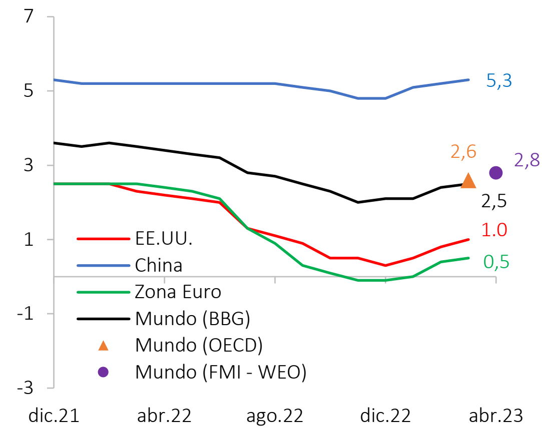
Global activity accelerates as services rebound



Source: Bloomberg and Santander

Global GDP growth projections for 2023 remain below 3%



Source: Bloomberg and Santander

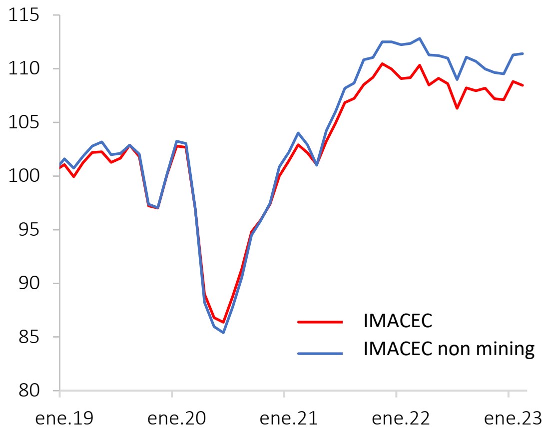
Local economic activity is stagnant

The February Imacec (-0.5 YoY; -0.3 MoM seasonally adjusted; 0.1% MoM seasonally adjusted excluding mining) confirmed that the economy has entered, after significant declines during the second and third quarters of 2022, a phase of stagnation, with diverging dynamics across sectors. Wholesale trade and some manufacturing branches have risen moderately due to a less intense adjustment of investment in machinery and equipment. Likewise, services have remained high due to the impulse of those linked to people's consumption. In contrast, the construction sector is already showing clear signs of decline, and mining continues to be punished, well below historical levels, due to low ore grades.

In March, there are some promising indicators. Although still in pessimistic territory, the monthly Business Confidence Index (IMCE) rebounded compared to February. Furthermore, daily trade sales reported by the Central Bank show a less pronounced decline than in previous months. Meanwhile, foreign trade figures for the month showed contrasting signs. On the one hand, exports rose strongly (US$ 9,760 million; 13.1% YoY), driven by mining shipments. On the other hand, consumer imports (US$ 1,690 million; -40.7% YoY) and capital imports (US$ 1,350 million; -19.3% YoY) continued to fall, reflecting a persistent weak demand. Thus, the trade balance increased significantly in the month, indicating a gradual improvement in the external figures.

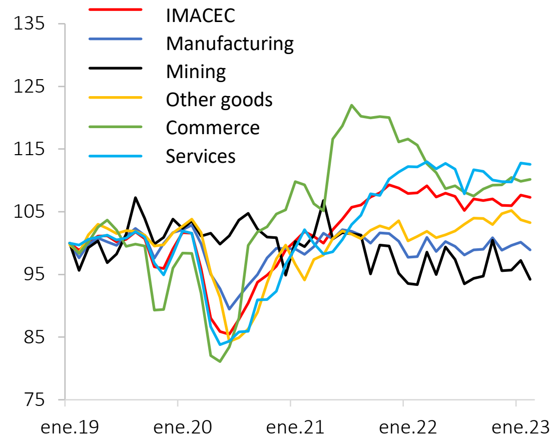
With the available background, we estimate that the March Imacec would have had a moderate monthly decline (-0.2% MoM seasonally adjusted) due to a drop in the services and construction sectors. Thus, and considering somewhat more demanding bases of comparison than in February, the annual change in activity would have fallen back to -1.2%. If this figure materialises, the year's first quarter would have a change of -0.6% YoY. For the year, we maintain our projection of a limited contraction of around -0.25%. This is slightly lower than the mid-point of the Central Bank's latest projection contained in the IPoM (0%) but slightly higher than the -1% projected by the International Monetary Fund in this week's update.

The latest Imacec reading shows that activity is stagnant



Source: Central Bank of Chile and Santander

Mining and Other goods declined marginally

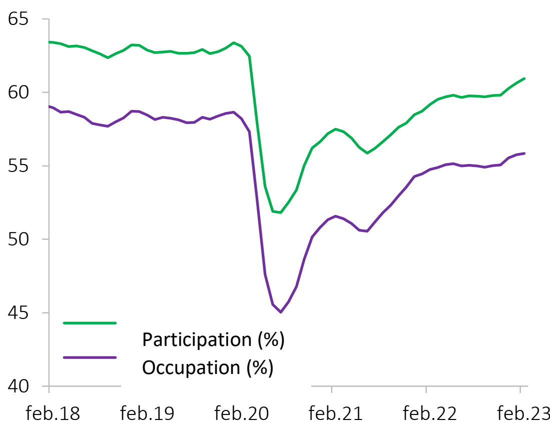


Source: Central Bank of Chile and Santander

Labour market deteriorates

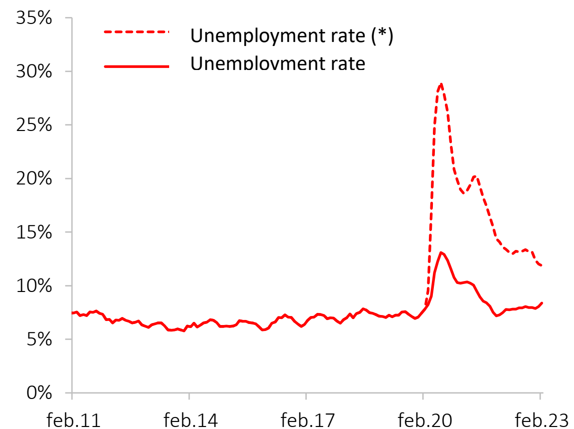
Employment continued to grow in February, albeit at a moderate pace (21,000 new jobs). This maintains a significant gap compared to the employment situation that would have prevailed without the pandemic. On the other hand, the labour force jumped significantly for the second consecutive month (59,000 additional persons in February), so the labour participation rate continued to increase (60.9%), although still far from pre-pandemic levels (around 63%). As a result, the unemployment rate rose significantly to 8.4%. Demand for labour remains subdued, with job vacancies well below historical averages. In this context, nominal wages declined in February (-0.2% MoM), in line with seasonal patterns. Thus, adjusting for inflation, real compensation continues to show year-on-year declines (-0.7% YoY).

Labour force rises more than employment but remains below historical patterns



Source: National Institute of Statistics and Santander

The unemployment rate would more than double with pre-pandemic participation



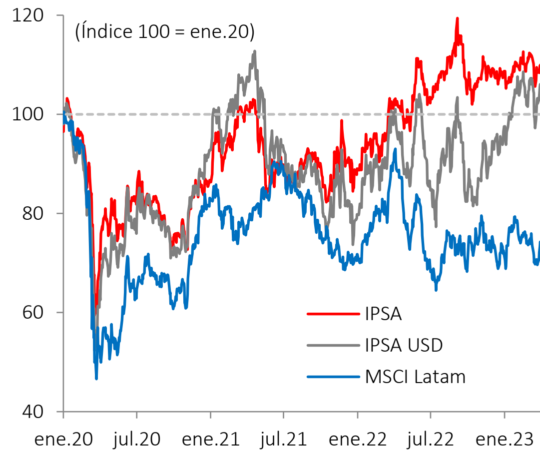
(*) It considers the participation rate at February 2020 levels.
Source: National Institute of Statistics and Santander

Financial assets on the lookout for renewed sources of uncertainty

Over the past few weeks, local markets have had mixed reactions, with relatively minor movements balancing out. In the latter part of March, as external financial conditions eased and risk appetite returned to the markets, the local exchange rate and long-term interest rates fell sharply (TC: $ 790 and BTP10: 5.2%), while the stock market partially recovered its levels before the global financial tensions, driven by the recovery of financial companies (Local stock index IPSA: 5,324 points at the end of March). Thus, the end of the first quarter was favourable for domestic financial assets. Nevertheless, in the case of interest rates, higher inflationary persistence, which would lead to sustaining tight monetary conditions for longer, caused them to rise sharply in recent weeks (BCP 10 +25 bps from 5.3% to 5.6%), decoupling from the downward trend of global benchmarks. The exchange rate, meanwhile, moved towards levels around $800.

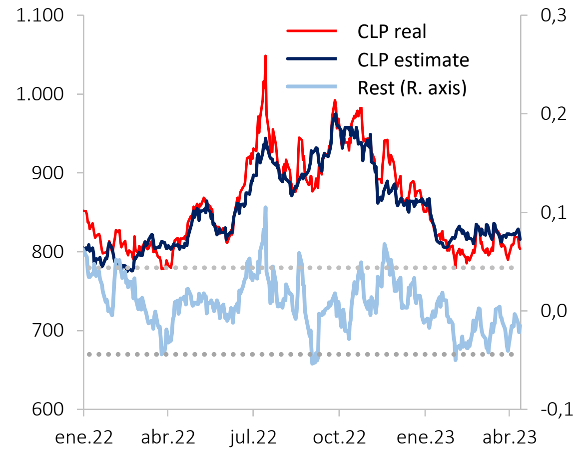
In the future, we anticipate that the currency will depreciate moderately to reach around $825 by the end of the year. This is as long as the copper price and the global dollar move towards their long-term values. This scenario assumes no further massive liquidity will be injected into the economy, specifically, the draft for a "sixth retirement" not being passed in Congress. If a further withdrawal of funds were to occur, financial assets would display losses not only from potential sales of instruments but also from higher risk premiums, implying higher interest rates and a significant depreciation of the exchange rate.

Local stock market partially recovers after external volatility scenarios



Source: Bloomberg and Santander

The exchange rate moves in line with its fundamentals



Source: Bloomberg, Central Bank and Santander

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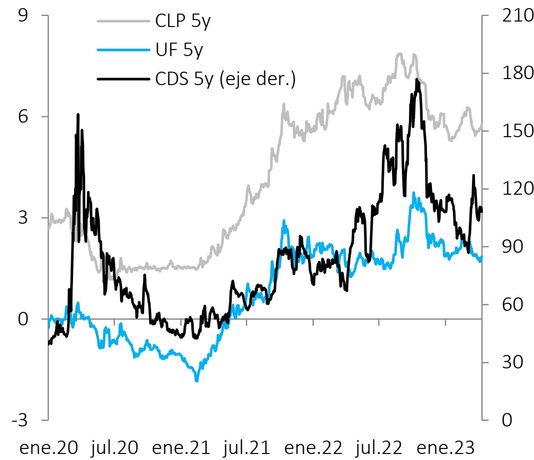
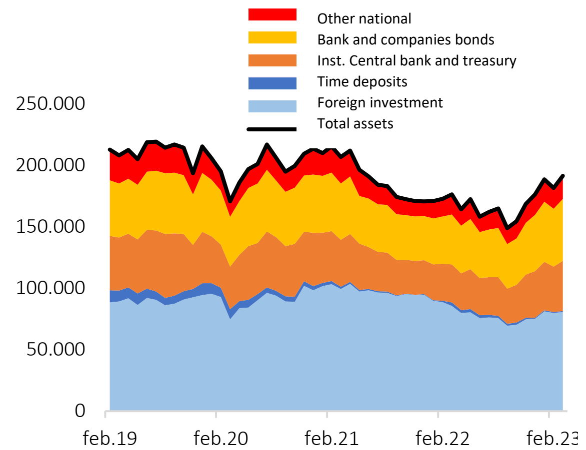
Interest rates rise amid higher risk premiums



Source: Bloomberg and Santander

Pension funds increase their holdings in domestic debt instruments



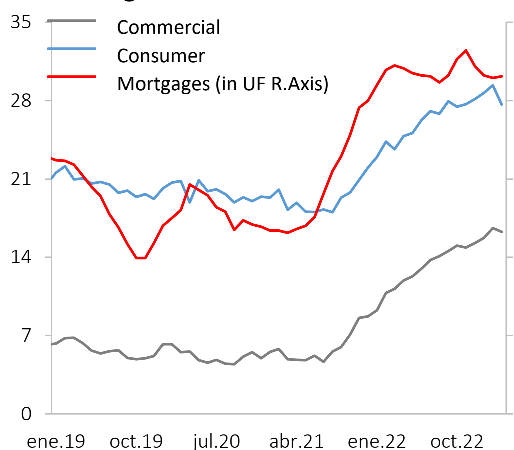
Source: Superintendency of Pensions and Santander

Economic environment continues to affect bank lending

Lower base rate pressures in March contributed to the relative stability of bank lending rates in the month, although they remain at elevated levels due to higher credit risk. In terms of amounts, bank lending remains in negative territory. Total lending declined by 3% YoY in real terms in March, mainly driven by the decline in the commercial portfolio (-5.8% YoY) and the consumer portfolio (-2.9% YoY). The Credit Survey suggests that this decline is due to a combination of more conservative standards, due to clients' credit risk, and weaker demand resulting from lower investment needs for firms and fragile employment and income conditions for individuals.

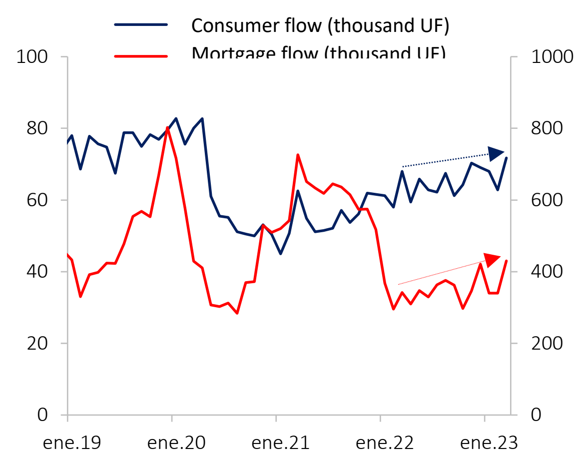
The housing segment continued to grow (1.3% YoY), with an increase in the flow of loans (26% YoY). The consumption segment also shows an acceleration in the flow, albeit moderate (5% YoY). In both cases, flows are still lower than those observed before the pandemic.

Bank lending rates stabilise



Source: Central Bank and Santander

Flows of credit to individuals rise marginally but remain low



Source: Central Bank and Santander

Inflation continued to fall in March, in line with expectations

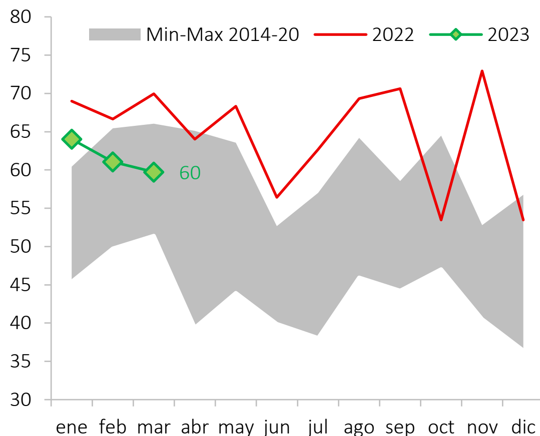
With an increase of 1.1%, the March CPI was consistent with market expectations (Bloomberg: 1.1%; Santander: 1.2%) and substantially lower than a year ago, so the year-on-year change in the CPI continued to decline (11.1% vs 11.9% in February and 12.3% in January).

As anticipated, the most relevant component was educational services (0.7% of incidence), whose indexation clauses link their values to the closing of the previous year's inflation. Moreover, some product and service categories surprised on the upside, such as clothing, rents and domestic services, the latter reflecting the second-round effects of previous CPI increases. On the other hand, items linked to the exchange rate exhibited significant falls, such as new cars (-0.1% of incidence), audiovisual equipment and cleaning products. Despite rising 0.4%, food moderated substantially from previous months and March 2022 (3.9%).

The change in the non-volatile CPI (the Central Bank's preferred measure of core inflation) increased by 1.6%, slightly above a year ago, bringing its annual change to 10.8%. It is important to note, however, that this measure includes educational services, and by excluding them, its monthly increase moderated to only 0.6%, and its annual change fell back to 10.6%. The inflation diffusion index declined again and was well below last year's level, in line with historical patterns.

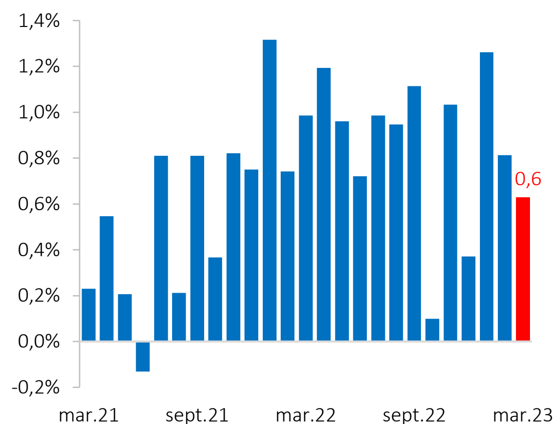
Although second-round effects continue to be observed, the March inflation figure reaffirms the moderating trend that price hikes have been exhibiting for some months now, making it clear that inflationary pressures have eased. This is consistent with deteriorating wage and employment data and shows that the economy has begun to generate the necessary slack to reduce inflation further, coupled with exchange rate appreciation and falls in commodity prices. We estimate that the CPI will increase by a limited 0.3% to 0.4% for April, bringing its annual change back to 10%. Subsequently, from May onwards, we will observe single-digit inflation to close the year at 4.7%, similar to the IPoM estimate.

Inflationary diffusion moderates again and aligns with historical patterns



Source: National Institute of Statistics and Santander

Non-volatile inflation, excluding education, fell in March



Source: National Institute of Statistics and Santander

Rate cuts may start earlier than expected by the Central Bank

Along with maintaining the Monetary Policy Rate (MPR) at 11.25% at its April meeting, the Central Bank published the March IPoM, where it revised its growth projections for 2023 (from -0.75% to 0%) and year-end inflation (from 3.6% to 4.6%) upwards.

Consistent with these revisions, the Council revealed a hawkish bias by raising the MPR corridor and reaffirming its discourse that, to initiate downward moves, they need to have sufficient confidence about the inflationary convergence to the 3% target. Thus, the central part of the corridor points to a first 75 bps cut only at the September Monetary Policy Meeting (MPM) instead of April, as implied in the December report. This would be followed by successive 75 bps cuts at the next meetings in October and December, ending the MPR at 9%, 100 bps above what they projected in the previous IPoM.

In response, market rates adjusted sharply upwards (1-year swap rates: 10.3%, up 60 bps from the previous Monthly Economic Outlook), although they still point to the rate starting to fall in the June MPR, earlier than the Council indicated, with more gradual moves to end around 9%.

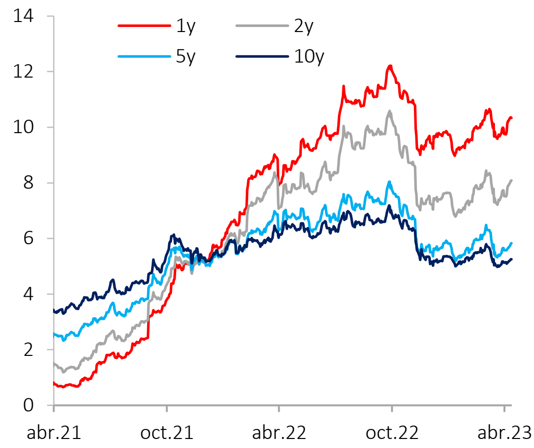
While starting the rate cut in September would allow the Board to have more information and certainty that the process of inflation reduction is well established, as well as the communication advantage of coinciding with an IPoM, we believe that sufficient conditions could be in place to start rate cuts as early as July.

Seasonal effects elevated the March inflation figure, which was consistent with market estimates. Furthermore, the non-volatile CPI change increased by 1.6% MoM, below the Central Bank's implied estimates. Therefore, if our scenario is realised, core inflation in April, May, and June would be below the IPoM projection by slightly more than 1pp. Furthermore, according to the recent Economic Expectations Survey, the market projection for two-year inflation remains at the 3% target. Moreover, the deterioration in the external environment could lead to a turnaround in US monetary policy as early as the second half of the year, all of which would advance the diagnosis that inflationary pressures have abated.

Thus, in our baseline scenario, we estimate rate cuts to start in July, with a 75 bps cut that would then accelerate to 100 bps at the September and October meetings, culminating in a further 75 bps cut in December, which would bring the MPR to 7.75%.

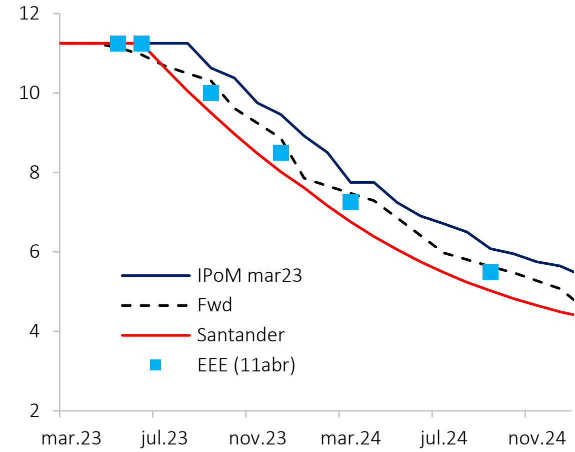
Alternatively, if inflation records do not ease as expected, the cuts could be delayed to the September meeting. In this case, we estimate a first decline of 75 bps, before adjusting more sharply and closing the year with the MPR at 8.5%, below the Central Bank's target rate.

Swap rates rise sharply after hawkish IPoM bias



Source: Bloomberg and Santander

MPR trajectory rises, and the first cut would start earlier than projected by the Monetary Policy Report (IPoM)



Source: Bloomberg, Central Bank and Santander

National Accounts	2017	2018	2019	2020	2021	2022	2023 P	2024 P
GDP (% real var. YoY)	1.4	4.0	0.8	-6.1	11.7	2.4	-0.25	2.5
Domestic demand (% real var. YoY)	2.9	5.0	1.0	-9.4	21.7	2.3	-4.2	3.2
Total consumption (% real var. YoY)	3.8	3.6	0.7	-6.6	19.3	3.1	-2.9	1.8
Private consumption (% real var. YoY)	3.6	3.8	0.7	-7.4	20.8	2.9	-3.7	1.7
Public consumption (% real var. YoY)	4.7	3.1	0.5	-3.5	13.8	4.1	0.8	2.1
Gross fixed capital formation (% real var. YoY))	-3.3	6.5	4.7	-10.8	15.7	2.8	-4.2	1.1
Exports (% real var. YoY)	-1.0	4.9	-2.5	-0.9	-1.4	1.4	1.3	1.4
Imports (% real var. YoY)	4.5	8.6	-1.7	-12.3	31.8	0.9	-9.2	3.5
GDP (US$ billion)	276.5	296.0	278.9	254.9	316.5	304.5	333.1	348.4
GDP per capita (US$ thousand)	15.0	15.8	14.6	13.0	16.1	15.2	16.7	16.6
Unemployment (% as of December)	6.5	7.1	7.1	10.3	7.2	7.9	8.2	7.5
Population (million)	18.4	18.8	19.1	19.5	19.7	19.8	20.0	21.0

Payment Balance	2017	2018	2019	2020	2021	2022	2023 P	2023 P
Trade balance (US$ billion)	7.5	4.4	3.0	18.9	10.5	3.8	6.1	7.4
Exports (US$ billion)	68.9	74.8	68.8	74.0	94.8	98.5	95.4	97.3
Imports (US$ billion)	61.4	70.4	65.8	55.1	84.3	94.7	89.4	89.8
Current account (US$ billion)	-7.6	-13.3	-14.5	-5.0	-23.2	-27.1	-14.4	-10.2
Current account (% GDP)	-2.8	-4.6	-5.3	-1.9	-7.5	-9.0	-4.2	-2.9
Copper price (year average US$/lb)	2.8	3.0	2.7	2.8	4.2	3.9	4.0	4.1
WTI oil price (year average US$/bbl)	50.9	64.8	57.0	39.0	68.0	94.0	79	81

Money and Exchange Market	2017	2018	2019	2020	2021	2022	2023 P	2023 P
CPI Inflation (% var. YoY up to December)	2.3	2.6	3.0	3.0	7.2	12.6	4.7	3.0
CPI Inflation (% var. YoY average)	2.2	2.4	2.3	3.0	4.5	11.6	8.0	3.6
CPI Inflation excluding food and energy (IPC-SAE) (% var. YoY up to December)	1.9	2.3	2.5	2.6	6.4	8.6	5.8	2.8
CLP/US$ exchange rate (annual exercise)	615	696	745	711	852	875	825	835
CLP/US$ exchange rate (year average)	649	640	703	792	759	873	812	830
Monetary policy rate (% annual exercise)	2.50	2.75	1.75	0.50	4.00	11.25	7.75	4.25
Monetary policy rate (% year average)	2.7	2.5	2.5	0.8	1.2	8.6	10.4	5.4

Fiscal Policy	2017	2018	2019	2020	2021	2022	2023 P	2024 P
Public expenditure (% real var. YoY)	4.8	3.5	4.1	11.0	31.6	-24.0	4.0	3.0
Central Government balance (% GDP)	-2.8	-1.7	-2.9	-7.3	-7.7	1.3	-2.5	-2.7
Central Gov. gross Debt (US$ billion)	68.9	70.2	74.4	91.6	102.0	117.3	134.9	146.3

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