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Inflation and geopolitical risks dominate the markets

Meanwhile, after January's intense CPI surprise in Chile, the Central Bank will continue to raise the Monetary Policy Rate (MPR) in the next two meetings, reaching between 7.5% and 8%.

Highlights

- **Inflation continues to rise globally, with signs of an extended spread.** Due to this, the Fed will continue raising rates during its next meeting, which is faster than considered until recently. As a consequence, the long-term interest rates have again risen during the month, and the dollar has strengthened.
- **The conflict escalation between Russia and Ukraine has increased volatility, pressured the main stock markets down, and weighed on fuel prices.** As of the date this report was issued, signs of distension provided some relief to markets. Nevertheless, the conflict will continue to pose a very relevant risk to the world's economy
- **In Chile, the activity ended 2021 with an unprecedented 12% growth.** However, some signs of a slowdown are becoming apparent, which will continue throughout the year as the demand reacts to the monetary contraction and the fiscal policy stagnates.
- **January's CPI gave an intense surprise on the upside, causing inflation to steepen up to 7.7%.** In the future, the second-round effects caused by the indexation of a series of services and the additional pressures of recent hikes on the international fuel price could cause inflation to continue rising. It could reach above 8% by the middle of the year, and then descend. Overall, prices will remain above target until mid-2024.
- **The Central Bank could raise the MPR in the next two meetings to a range of 7.5% and 8%.** The substantial rise in inflation and its medium-term prospects, the still ample liquidity available, and exchange risks make it necessary to continue raising the governing rate. Notwithstanding, as the economy slows down and the inflation starts to relent by the end of the year, the Central Bank will have more leeway to apply a speedier reduction.
- **The fiscal deficit ended 2021 at 7.6% of the GDP, slightly less than previously estimated.** In times to come, the sharp spending reduction will cause it to shrink to levels around 1%. All things considered, public spending will continue climbing, nearing 40% next year.

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Geopolitical tensions aggravate the global inflation scenario

Inflation remains one of the most significant macroeconomic concerns at a global level. Prices have continued to surprise on the upside in different countries, which has caused interest rates to experience relevant hikes in the medium and long term. The latter situation adds to the geopolitical tensions concerning the conflict between Russia and Ukraine, raising fuel prices, and increasing financial volatility.

In the US, January's price figures reached above expectations (CPI: 0.6% MoM vs 0.4%; PPI: 1% MoM vs 0.5% expected), and inflation climbed up to 7.5% - its peak in 40 years-, reflecting not only the impact of value chain disruptions and the fuel hikes but also its influence on services. This triggered a rise in long-term returns, driving the 10-year treasury bills rate to 2%. The latter has strongly pressured the Federal Reserve into starting the raising-rates process, which would begin in their coming meeting in March and turn out faster than anticipated in recent weeks, as indicated in their last Minute. Therefore, a 50-bps increment in their next meeting is likely.

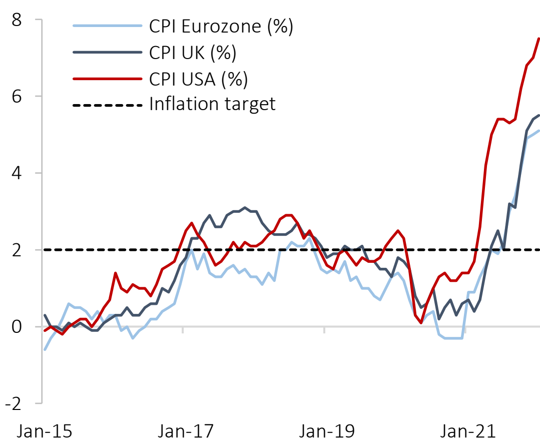
In Europe, inflation has also experienced a relevant rise (January's CPI: 0.3 MoM vs -0.4% estimated). However, conversely to the Fed's approach, the ECB has taken a more cautious stance and stated the necessity to continue its stimulus policies.

Despite the Covid-19 wave of contagion linked to the Omicron variant, the global activity continues to evolve positively. January's preliminary PMI figures were aligned with expectations, showing that the recovery process continues its course, though at a slower pace than in previous months (global composite PMI: 51.4 VS 54.3 in December). In China, January's PMI figures remained around the neutral 50, reflecting the impact of the strict measures intended to contain the contagion and the difficulties its retail sector is suffering.

The conflict between Russia and Ukraine has introduced new volatile elements, raising fuels prices and pressuring markets down, with sharp drops in stock indexes (global MSCI: -4%). As of the date this report was issued, the Russian authorities' announcement to partially withdraw some troops from Ukraine's frontier was received positively, which provided relief. As a result, the VIX retreated, and the dollar vigorously strengthened globally (DXY: 1%).

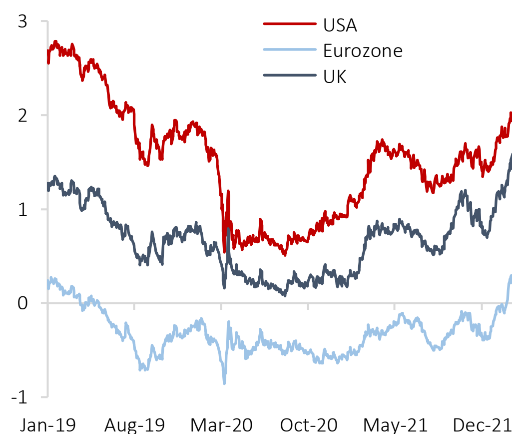
The prices of some essential commodities suffered due to the above situation, with record new peaks last month, particularly WTI oil which reached 95 US$/lb – an unseen level since 2014-, already accruing a 22% growth insofar this year. Russia's prominence as a gas supplier to Europe is an element to consider in the current context and further strains an already pressured market by the tight offer due to OPEC's cuts and the demand's buoyancy. The resolution to this conflict will significantly determine the trend that fuel prices will follow in the short term, which will weigh into the already high pressure on global inflation and future monetary policy strategies.

Inflation continues to surprise on the upside in leading economies



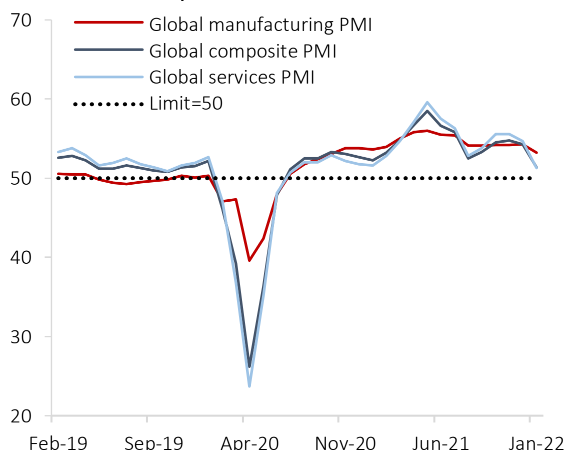
Source: Bloomberg and Santander

Long-term rates steepen up



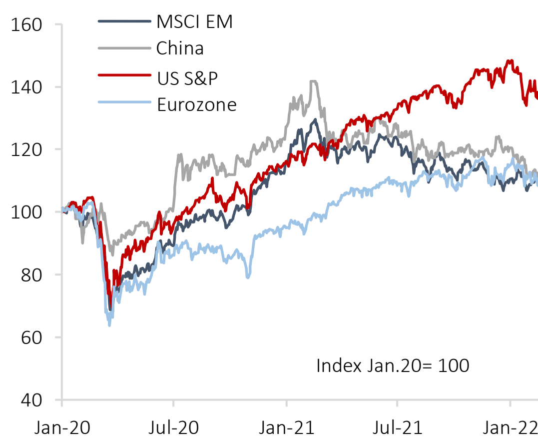
Source: Bloomberg and Santander

Global economic outlooks moderate, reflecting caution at still prevalent risks



Source: Bloomberg and Santander

Global markets retreat at imminent rate hikes and geopolitical tensions



Source: Bloomberg and Santander

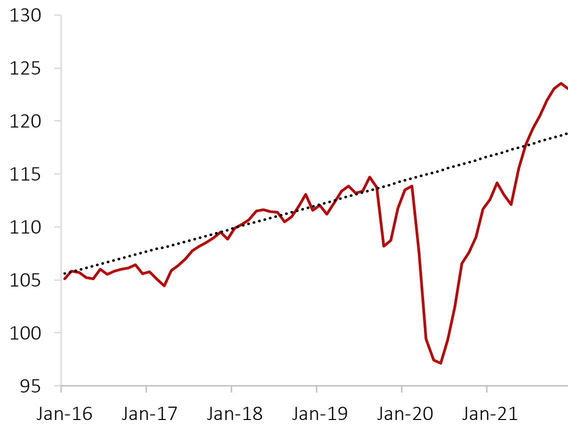
Despite the high growth, the local activity shows signs of a slowdown

The economy ended 2021 with an unprecedented 12% growth, reaching quite above its trend. Nevertheless, figures marginally reflected a slowdown, with a negative monthly variation on the Imacec (-0.4%). This fall was primarily affected by the month's contraction of mining and the decrease in manufacturing and commerce activities compared to November figures. Services and construction, in the meantime, continued to progress.

In times to come, activity should moderate towards its trend. The lower fiscal stimulus and the monetary contraction should push consumption back, even if the still-available high liquidity could delay the adjustment. Meanwhile, investment should stagnate due to the tighter financial conditions and the internal political uncertainty. As a result, we estimate that the Imacec had a yearly growth between 9% and 9.5% in January. We uphold our baseline scenario of 2.5% growth for the year, though several factors introduce a

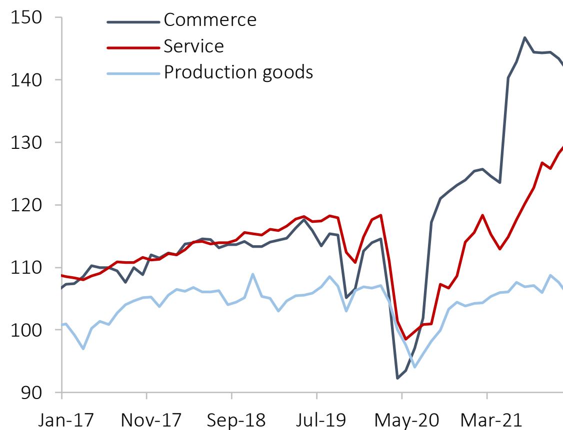
downwards bias to this prospect. We will review figures after the 2021's National Accounts ends in mid-March.

The IMACEC would begin returning to its trend



Source: Banco Central and Santander

Commerce already displays an apparent moderation

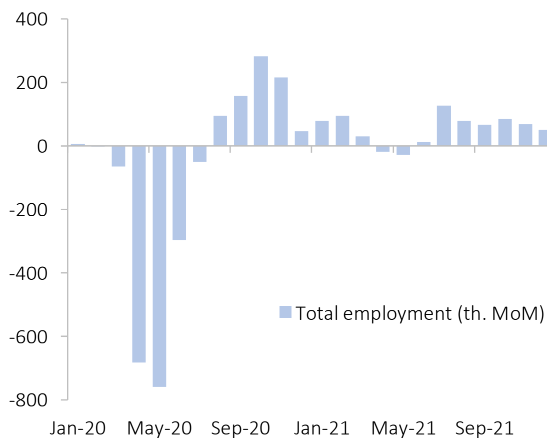


Source: Banco Central and Santander

Employment creation continues, but the gap over pre-pandemic levels remains.

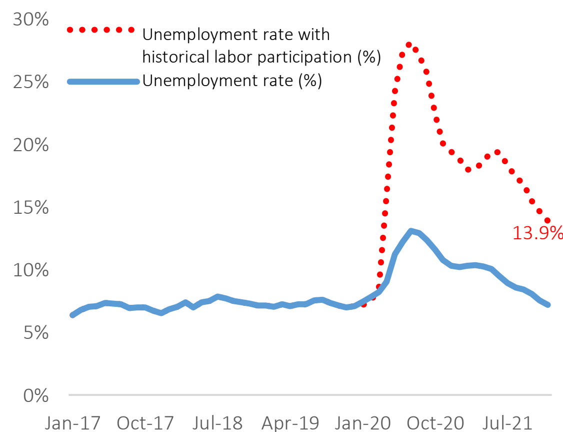
Close to 120 thousand jobs were created in December, leading to a new reduction to the unemployment rate, which ended the year at 7.2%. Despite this, employment remains well below its pre-pandemic levels, with close to 450 thousand fewer jobs than in February 2020, which is explained primarily by a restricted labour offer. Indeed, even as the demand for work has increased substantially, labour participation remains low.

Employment continues to recover



Source: INE and Santander

The unemployment rate decreases, but a substantial gap still remains



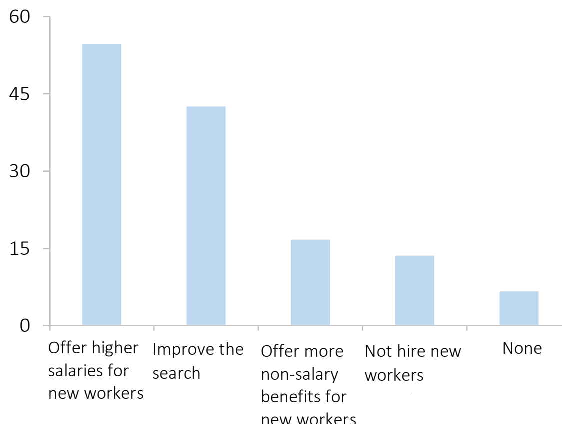
Source: INE and Santander

The above is strengthened by the evidence in the last Business Perception Report, which shows that 88% of businesses surveyed indicate it has become harder to fill vacancies, a higher percentage than the end of 2021. Thus, companies have increased wages – which rose 6.8% in nominal terms last December-or have altogether desisted in their pursuit and instead hastened their automation processes.

The work offer remains very limited

Source: INE, Banco Central and Santander

Companies adopted different measures to deal with the lack of workers



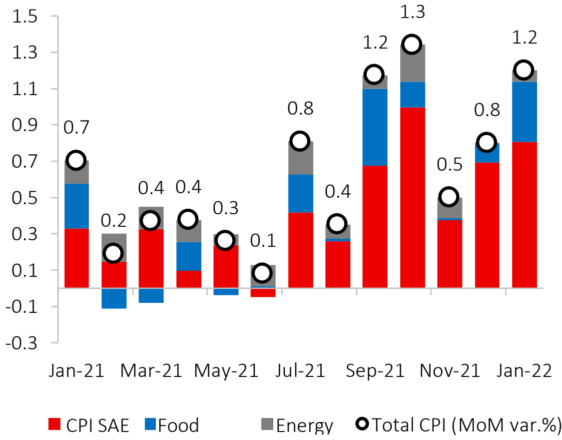
Source: Banco Central and Santander

January's CPI sharply surprises on the upside

With a 1.2% monthly variation, quite above the market's expectations (Bloomberg: 0.6%), January's CPI surprised strongly on the upside, expanding 7.7% in 12 months (7.2% in December), its peak since 2008. The figure was particularly affected by the foods and transport segments. In foods, the hikes to bread, meats, lemons, and drinks can be highlighted, whereas, in transport, the airline fares (10.9% MoM; incidence 0.10%) and new cars (2.6% MoM; incidence 0.09%) stood out.

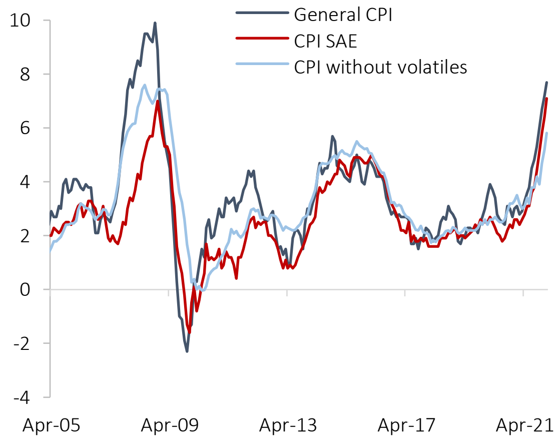
Beyond isolated hikes, January's CPI reflected the more generalized effects on prices derived from a solid internal demand, the end-of-year exchange rate depreciation, and the climb of international costs. Therefore, underlying measures exhibited significant rises (CPI without volatile components: 1.2%; CPI SFE: 1.1%), and the Dispersion Inflation Index (percentage of items in the basket that have increased their price) displayed its highest level in recent years.

Underlying component largely explain the surprise in January's CPI



Source: INE and Santander
Note: SAE = sans food and energy

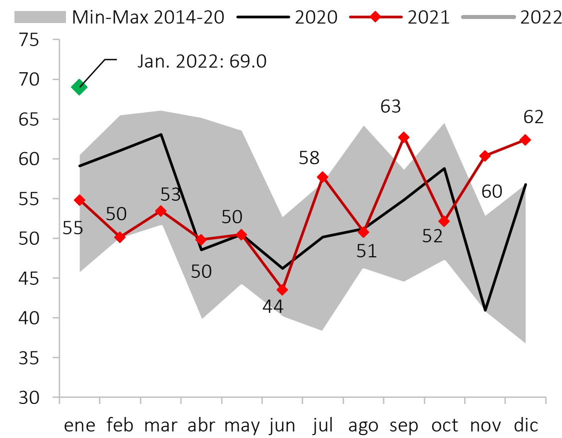
Inflation reaches its highest figure since the end of 2008



Source: INE and Santander

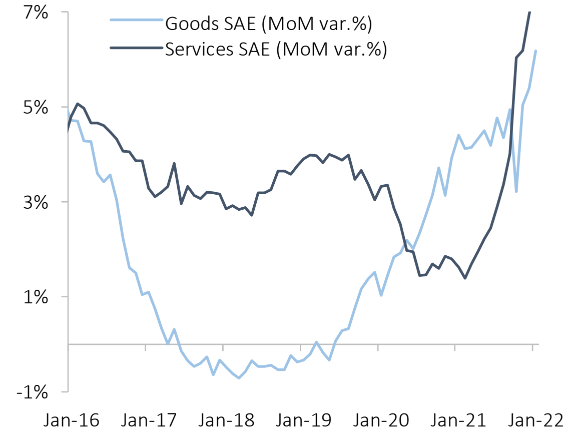
In the short term, second-round effects due to the indexation of some services to the prior inflation, added to the impact of the recent hikes on international fuel prices, should cause inflation to remain high, surpassing 8% mid-year. The figure should then moderate, ending 2022 at around 6%. As a result, inflation should stay above target next year and converge to 3% by mid-2024.

Inflation dispersion reached record levels in January



Source: INE and Santander

Both goods and services prices have risen rapidly



Source: INE and Santander

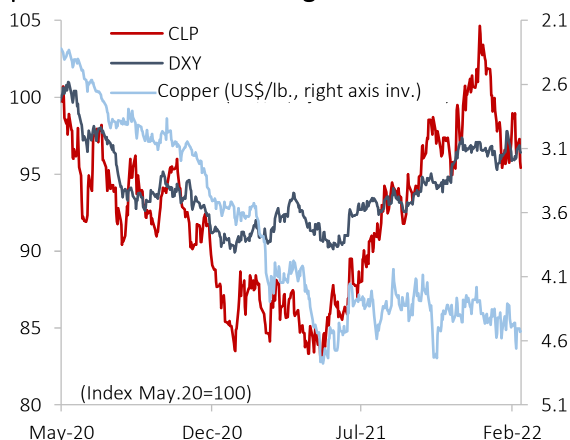
Local financial markets display high volatility

Financial assets were again subjected to high volatility during the month due to several factors. Firstly, there was a sharp rise in Covid-19 infections, which, despite not having the same impact as previous waves, still remains a relevant risk factor. Secondly, there is political uncertainty after a series of measures were approved by different commissions of the Constitutional Convention, which pose challenges to growth.

Thirdly, the geopolitical tensions arising from the crisis in Ukraine have also affected local markets. Finally, the above is compounded with an intense inflation surprise in January, which caused a sharp steepening of the shorter part of the yield curve.

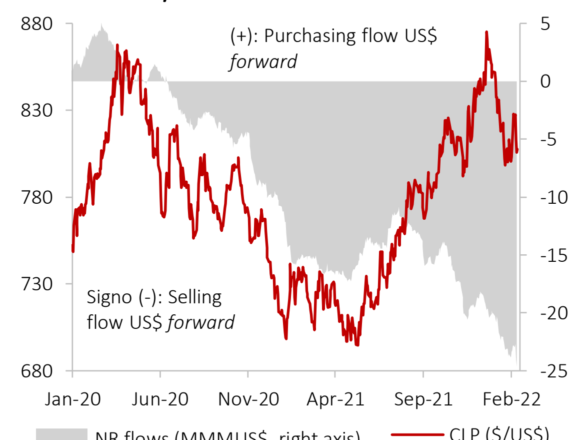
The substantial increment to the MPR by the end of January and the higher prospects of further hikes have exerted pressure downwards over the exchange rate in recent weeks, being traded at around $800. In this context, a growing bet favouring the local currency on behalf of non-resident investors has been observed- over US$ 2.6 million during the last month- alongside a higher sales pipeline from pension funds due to the movement of members to funds with more robust national investments. In turn, the elevated price of copper, which surpassed the US$ 4.6 per pound and recorded its highest peaks in the last four months, has also contributed to the strengthening of the Peso.

High copper price levels exert downwards pressure over the exchange rate



Source: Bloomberg and Santander

Non-resident investors increase their bet on the local currency

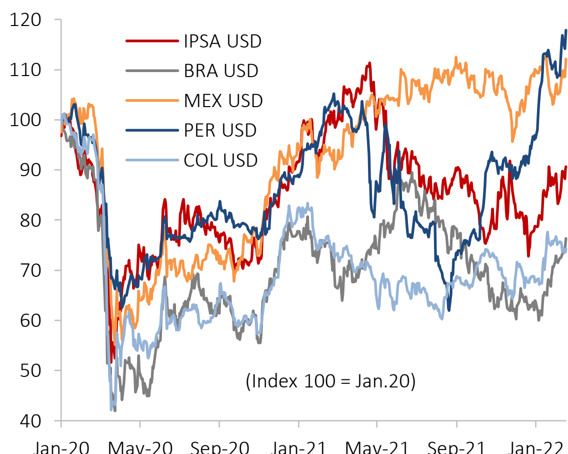


Source: Bloomberg, Banco Central and Santander

The vigorous growth of the economy and some signs given by the new government— the cabinet formation and the restatement to commit to the fiscal consolidation— have allowed the recovery of riskier assets. Consequently, the local stock has shown a decisive recovery (Local stock index IPSA: 4,653 points; 4.0% MoM and 7.0% MoM measured in dollars), settling as one of the stocks with better results from the entire region. Nevertheless, the expectation of higher interest rates and the persistence of political risk are factors that may cap more significant rises.

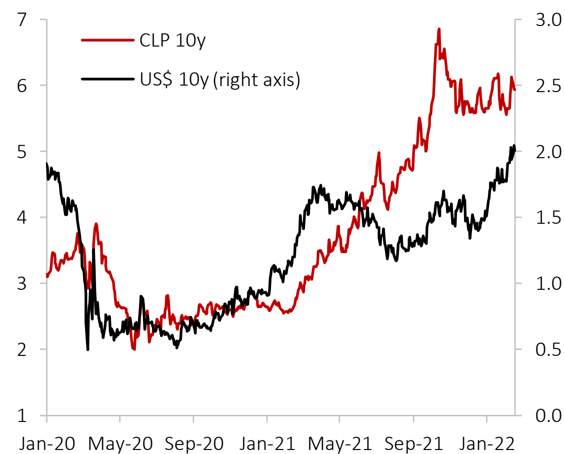
The long-term interest rates were relatively stable throughout the month, both in nominal and UF terms. Conversely, the short-term rates strongly climbed following the inflation surprise (BTP: +124 bps up to 7.5%), and the UF rates tended to fall (BTU: -17 bps up to 1.5%). The latter entailed a larger inversion of the yield curve. In the future, the tightness of international financial conditions –which is already coalescing after the vigorous growth of bond rates in the US–and the persistence of geopolitical tensions at a local and international level could exert pressure on the risk primes and once again raise the long-term rates.

Local stock market leads returns in the region during the last month



Source: Bloomberg and Santander

Inflation pressures and hikes to international rates raise the local benchmarks



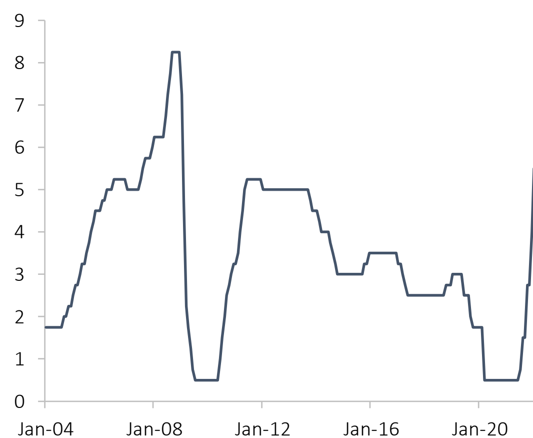
Source: Bloomberg, the Central Bank and Santander

Monetary Policy Rate would continue to rise in the next two meetings

In their first meeting of the year, the Central Bank again undertook an aggressive MPR raise of 150 bps, pushing it to 5.5%, its highest levels since early 2009 and quite above its long-term neutral value. This rise was somewhat above ours and most of the market's expectations (125 bps).

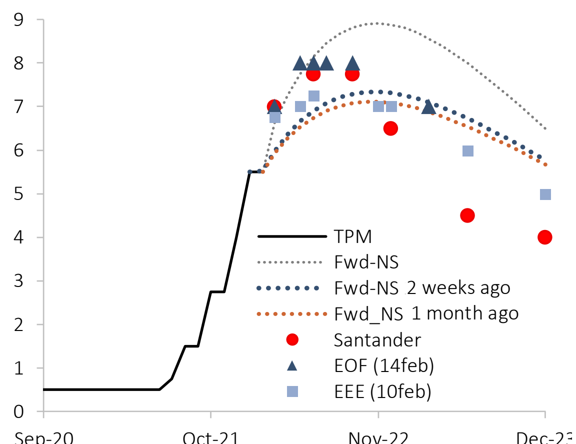
Before January's inflation figures, we anticipated the Council could raise the MPR in March to reach between 6.5% and 7%, to then maintain this level until the last quarter of the year. Nonetheless, last month's surprising CPI suggests that inflation pressures are more expansive, and the risks of converging into the target are higher, which is why more intense hikes to the MPR are more likely in the short term. Therefore, we may again observe a 150 bps increment in March, followed by a 50 to 100 bps rise in May – depending on the evolution of the different inflation-related risks–with which the MPR could reach between 7.5% and 8% by the second quarter's ending. The rate would remain stable for a large part of the year from this moment onwards. However, as the activity loses dynamism and inflation pressures relents in the last quarter, the Central Bank could begin a gradual lowering process. Overall, we estimate that by December 2022, the MPR will not stand below 6%, reaching 4.5% by the end of 2023.

MPR hiking process speeds up



Source: Bloomberg, Banco Central and Santander

Prospects of future hikes intensified after the inflation surprise



Source: Bloomberg and Santander

Public spending closed 2021 with a record expansion

Just as projected, government spending had an unprecedented 33.2% growth (31.3% of the GDP) during 2021, reflecting the pandemic-related state aid (Universal Emergency Family Income). Incomes also experienced a significant rise (37.8% YoY) due to the vigorous economic growth, the high price of copper, and the reversal of a series of tax relief measures implemented in 2020. With this, the deficit ended the year at 7.6% of the GDP, a high figure but somewhat lower than projected until some months ago. The gross debt, in the meantime, climbed up to 36% of the GDP, almost 4pp above the figure ending 2020.

Spending will display a substantial contraction in times to come, as the budget does not contemplate further state aid. The recently approved Guaranteed Universal Pension (PGU) will be gradually implemented, involving a disbursement amounting to 0.4% of the GDP for this year, of which 0.3% of the GDP were already considered by the Budget Law. Therefore, according to our calculations, total spending would experience a real drop of over 24%. Incomes will also shrink though more moderately, by around -4%, due to the slowdown of the economy, the lower average copper price, and basal effects of the 2020 tax measures reversal. With this, we estimate the year's deficit to reach around 1% of the GDP, in line with the prospect of the last Dipres Public Finances Report. The debt, in turn, will climb up to 38.9% of the GDP, according to our estimates, due to the deficit and the acquisition of financial assets (FEES injection of resources).

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Macroeconomic Projections

National Accounts	2016	2017	2018	2019	2020	2021 e	2022 P	2023 P
GDP (real var. % YoY)	1.7	1.2	3.7	0.9	-5.8	12.0	2.5	0.5
Internal demand (real var. % YoY)	1.8	2.9	4.5	1.0	-9.1	21.2	0.3	1.0
Total consumption (real var. % YoY)	3.5	3.6	3.7	0.8	-6.9	18.6	-0.8	2.2
Private consumption (real var. % YoY)	2.7	3.4	3.8	1.0	-7.5	20.6	-0.7	2.0
Public consumption (real var. % YoY)	7.2	4.6	3.3	-0.2	-3.9	11.0	-1.5	3.5
Gross fixed capital formation. (Real var. % YoY)	-1.3	-3.1	5.1	4.4	-11.5	17.2	-0.6	1.8
Exports (real var. % YoY)	0.5	-1.5	5.3	-2.6	-1.0	-0.9	1.9	2.5
Imports (real var. % YoY)	0.9	4.6	8.1	-2.4	-12.7	30.3	-3.7	4.0
GDP (US$ billions)	250.6	277.1	298.2	279.8	253.7	310.0	307	320
GDP per capita (US$ thousands)	13.8	15.0	15.9	14.6	13.0	15.7	15.5	16.0
Population (millions)	18.2	18.4	18.8	19.1	19.5	19.7	19.8	20.0

Payment Balance	2016	2017	2018	2019	2020	2021 e	2022 P	2023 P
Trade balance (US$ billions)	4.9	7.4	4.2	3.0	18.3	13.0	27.5	13.3
Exports (US$ billions)	60.7	68.8	74.7	68.8	73.4	94.7	96.5	85.0
Imports (US$ billions)	55.9	61.4	70.5	65.8	55.1	83.8	69.0	71.7
Current account (US$ billions)	-5.0	-6.4	-11.6	-10.5	3.4	-18.6	-9.2	-8.0
Current account (GDP%)	-2.0	-2.3	-4.0	-3.7	1.4	-6.0	-3.0	-2.5
Price of copper (annual average, US$/lbs.)	2.21	2.80	2.96	2.72	2.80	4.2	4.2	4.0
WTI oil price (annual average US$/bbl.)	43.2	50.9	64.8	57.0	39.0	68	78	80

Money and Exchange Market	2016	2017	2018	2019	2020	2021	2022 P	2023 P
CPI Inflation (var. YoY, % by December)	2.7	2.3	2.6	3.0	3.0	7.2	6.1	4.2
CPI Inflation (var. YoY, average %)	3.8	2.2	2.4	2.3	3.0	4.5	7.8	4.6
CPI sans food and fuel inflation (IPC-SAE) (var. YoY, % by December)	2.8	1.9	2.3	2.5	2.6	6.4	4.6	4.1
CLP/US$ exchange rate (year's exercise)	667	615	696	745	711	852	850	860
CLP/US$ exchange rate (year average)	677	649	640	703	792	759	851	855
Monetary policy rate (year's exercise, %)	3.50	2.50	2.75	1.75	0.5	4.0	6.5	4.0
Monetary policy rate (%, year average)	3.5	2.7	2.52	2.48	0.8	1.2	7.0	4.7

Fiscal Policy	2016	2017	2018	2019	2020	2021 e	2022 P	2023 P
Public expenditure (real var. % YoY)	3.8	4.8	3.5	4.1	11.0	31.6	-24.3	-2.9
Central Government balance (% GDP)	-2.7	-2.8	-1.7	-2.9	-7.3	-7.6	-2.8	-0.9
Central Gov. gross Debt (US$ billions)	53.4	68.9	70.2	74.4	91.6	102	119	122

Source: BCCh, INE and Santander.

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