Federal Reserve's stance changes and puts stress on global financial markets

Further inflationary surprises intensify the tightening of global financial conditions and lead to sharp corrections in asset prices.

Highlights

- **The Federal Reserve implements an aggressive rate hike.** The surprising CPI for May in the US and a still robust labour market led to an unprecedented 75 bps increase in the benchmark rate, above expectations, and the announcement of further hikes in the coming meetings. In addition, the European Central Bank will begin its stimulus withdrawal in July, while the Bank of England will continue to raise its rate.
- **Global markets show widespread adjustments.** Tightening financial conditions and latent risks from the war in Ukraine and confinements in China have led to severe stock market declines, increases in long-term rates and global strengthening of the dollar.
- **The local economy will begin to slow down in the coming months.** The Imacec in April, while contracting marginally (-0.3% MoM), corroborated that the sectors linked to consumption still show resilience. Nevertheless, evidence suggests that investment is already moderating. Thus, we maintain our annual growth projection at around 1.5%.
- **Local financial assets are coupled with international volatility.** The local stock index IPSA and the exchange rate reversed the profits made at the end of May - with significant losses in June - in line with the drop in the copper price and an increased risk aversion.
- **The CPI for May (1.2%) continued to show strong inflationary pressures.** In the short term, prices will continue to rise due to further rises in international oil and food prices and a higher exchange rate. Therefore, we expect the annual change in the CPI to rise to 12.5% in June and then begin declining in the second half of the year to end at around 10%.
- **According to expectations, the Central Bank raised the MPR to a historical high of 9%.** This, together with a somewhat more hawkish Monetary Policy Report (IPoM), suggests that the rate will continue to rise by at least 50 bps before ending the hiking cycle. As inflation and activity data moderate, the tapering process could begin towards the end of the year or early next year.

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Growing global inflation accelerates monetary stimulus withdrawals

Since our last monthly report, global inflationary pressures have continued to rise. Oil prices have reached their highest levels in over a decade, and CPI data in leading countries have risen again (US: 8.6% YoY vs 8.3% previously; Eurozone: 8.1% YoY vs 7.5% previously; UK: 9% YoY vs 7% previously). This has led markets to bid heavily on the quick withdrawal of monetary stimulus, backed by more aggressive statements from major central banks.

The Federal Reserve raised its benchmark rate by 75 bps, above market consensus expectations, and delivered a hawkish bias for its policy guidance in the future. While Chairman Jerome Powell stated that rate hikes of a similar magnitude would be infrequent, the projections provided by the dots point to substantial rate hikes this and next year. Therefore, while the Fed expected to close 2022 with its policy rate in the 1.75%-2% range until March, it now projects it ending in the 3.25%-3.5% range. This implies further 175 bps hikes over the coming four meetings. For 2023, the dots suggest a further 50 bps increase to end the hiking cycle with the rate between 3.75% - 4%, well above what it had estimated in March (2.75%-3%) and in December last year (1.5%-1.75%).

This bias had previously been internalised by the market, although prices were pointing to a faster pace, ending this year with the rate already close to 4%. Nevertheless, the Fed's concerns about inflation and upward inflation trends over the coming months could lead to further corrections in market prices, with additional rate hikes - before the Fed's decision, long-term sovereign bond yields had risen by more than 50 bps while the 10-year rate was at its highest level in more than a decade (Q10: 3.3%) - alongside stock market declines and a further global strengthening of the dollar.

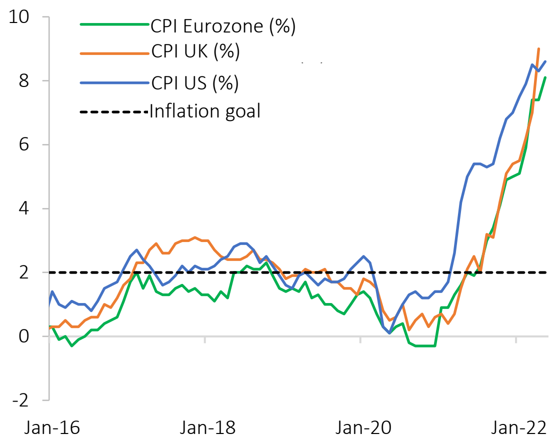
The European Central Bank (ECB), which already announced its first rate hike in over a decade (+25 bps) in July, held an emergency session prior to the Fed meeting to develop a plan to reduce the fragmentation observed in the EU bond market. The start of the rate hike process and the imminent end of the asset purchase programme had begun to pressure the sovereign rates of the most indebted European countries. Therefore, the plan the ECB is preparing seeks to avoid a significant gap between the prices of these bonds and those of the more stable countries.

The significant rise in interest rates, coupled with the extension of the war in Ukraine, has increased the likelihood of a global recession. As a result, several international organisations have substantially revised down their growth expectations for the year (World Bank: from 4.1% to 2.9%; OECD: from 4.5% to 3%). Meanwhile, the Fed significantly cut its growth projections for this year, from 2.8% to 1.7%.

In this context, there have been generalised adjustments to asset prices, with significant falls in the main stock markets (MSCI global: -4% in the month; MSCI Latam: -2%; US: -4%; Eurozone: -3%; UK: -1%). The dollar, by contrast, has strengthened as a result of both the US rate hike and greater risk aversion. Thus, it has reached its highest level since 2002 (DXY: 105 points).

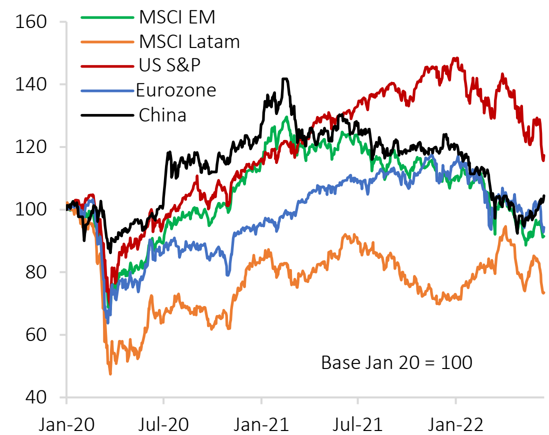
Unlike leading countries, Chinese assets have recovered their value in recent weeks. After the end of the lockdown measures that affected the population of major cities for almost two months, there was a partial recovery in activity (manufacturing PMI: 48.1 May vs 46 April; services PMI: 41.1 May vs 36.2 April; retail sales: -6.7% YoY vs -11.1% previously; industrial production: 0.7% YoY vs -2.9% previously), and the stock market rose strongly (CSI 300: +8%). Nevertheless, the risks to the country's economy remain high as the authorities maintain their zero-tolerance policy on Covid-19, which could mean further restrictions in the future.

Global inflation continues rising...



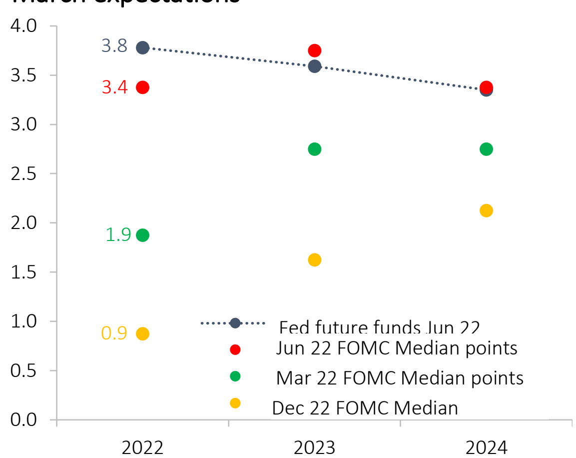
Source: Bloomberg and Santander

...and risk assets respond with drops



Source: Bloomberg and Santander

Fed sharply corrects rate path up compared to March expectations



Source: Bloomberg, Federal Reserve (Fed) and Santander.

Long-term government bond yields continue their upward trend

Source: Bloomberg and Santander

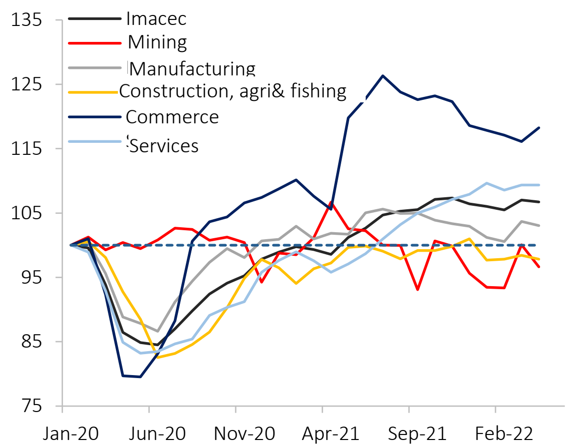
Local activity remains driven by consumer spending, but a significant slowdown is expected

The Imacec contracted moderately in April (-0.3% MoM seasonally adjusted), dragged down by the decline in mining (-3.4% MoM seasonally adjusted) after its strong rebound in March. On the other hand, consumption-related sectors (trade and services) remained strong, while those associated with capital formation (manufacturing and "other goods", which includes construction) showed weakness. Thus, some of the trends observed in the first months of the year have continued, with consumption showing some resilience and investment declining.

In the future, we project that both demand components will show a slowdown in momentum. Surplus liquidity has been dampened by the sharp rise in interest rates, while employment income has deteriorated. Both are due to the loss of buoyancy in job creation (40,000 on average in the quarter ending April vs 85,000 in the quarter ending January) and the drop in real wages caused by inflation. Furthermore, demand for work has weakened marginally.

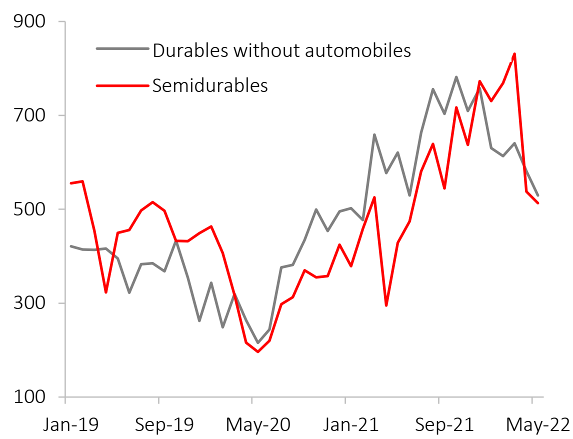
In turn, imports of some lines linked to consumption (non-automotive durables; semi-durables) continue to decelerate significantly. These factors, coupled with tighter credit standards, will cause consumption to fall back in the coming months.

Consumer-linked sectors have remained resilient



Source: Central Bank and Santander

Imports contract sharply



Source: ANAC and Santander

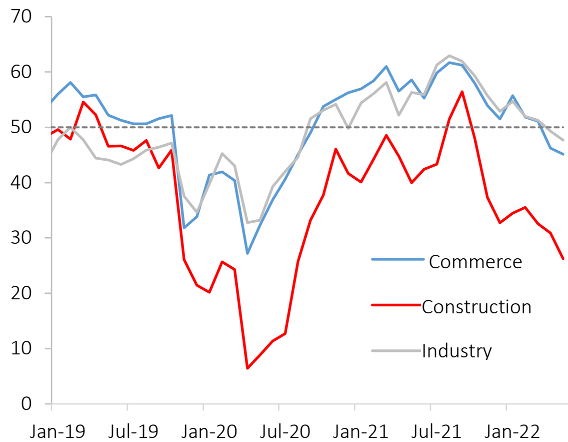
Furthermore, the investment scenario remains complex. A high level of uncertainty compounds the tightening of financial conditions due to the domestic political environment. Several measures of business confidence have shown a severe deterioration in recent months, with a slowdown in the number of projects approved by the Environmental Assessment Service. This suggests a prolonged slowdown in capital formation. In the external sector, the fall in the trade terms and the weakening of global growth will impact the export sector.

Accordingly, there was a significant decline in lending activity. Total loans grew 2.7% YoY in real terms during May (vs 3.3% in April), reflecting the adjustment the economy is already starting to experience and tighter financial conditions. Corporate lending rose only 2.9% in real terms, consistent with lower investment projects and a higher credit risk environment. Likewise, lending to individuals has moderated. Mortgage lending rose 3.4% YoY, almost at half the pace of growth in 2021, with flat monthly growth. Weaker housing sales and subdued job and income prospects have led to the slowdown in this segment. Finally, consumer loans remained in negative territory (-1.3%), although at lower figures than the previous month.

Against this background, we maintain our growth outlook for the year at around 1.5%, somewhat below the midpoint of the last monetary policy report's range (1.5% - 2.25%). This entails that, after the last two quarters –which have displayed high growth due to low comparison bases – we will see negative figures in the year's second half. We estimate that the Imacec would have had an annual expansion of close to 5% in May.

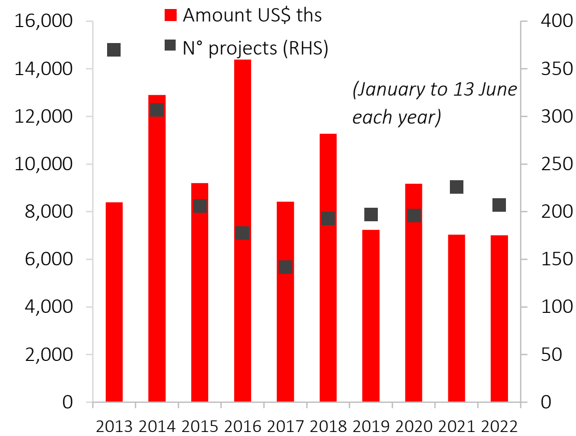
For now, we maintain our projection for next year's activity growth at around 0.5%, above the range presented by the Central Bank (-1% - 0%). Nonetheless, once the National Accounts figures are known - due on August 18 - we will review the macroeconomic framework and likely correct down the growth figures for 2023.

Business confidence continues to deteriorate, remaining in the pessimistic territory



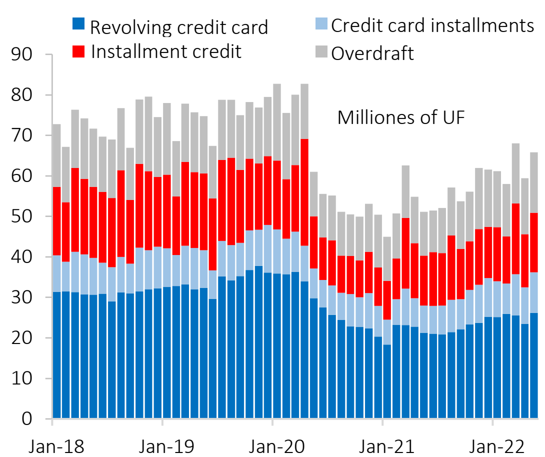
Source: ICARE and Santander

Projects approved by the Environmental Impact Assessment System (SEIA) remain low.



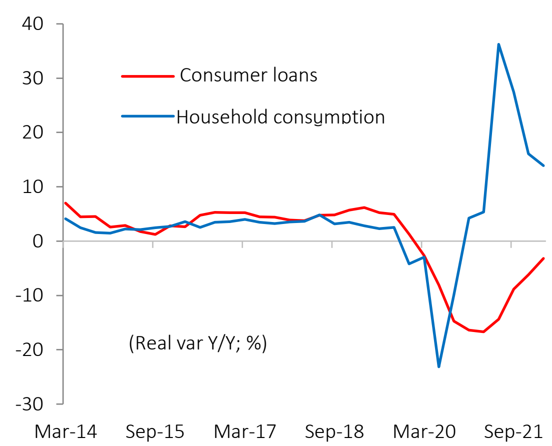
Source: SEA (Environmental Assessment Service) and Santander.

Consumer credit flows accelerate marginally...



Source: Central Bank and Santander

...consistent with a high level of household consumption



Source: Central Bank and Santander

Local markets follow the global trend and descend during the month

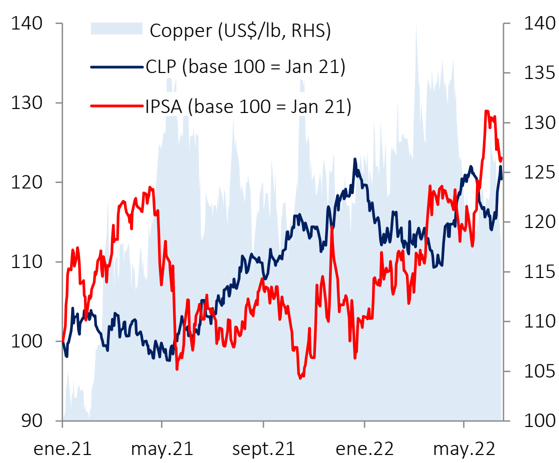
Financial prices in Chile have been subject to strong volatility, keeping pace with their international benchmarks. As a result, the stock market retreated sharply during the last period, after accruing profits late in May and reaching its highest level since February 2019 (5,380 points), in line with the global corrections of the main financial assets. Nonetheless, at the close of this report, the IPSA was trading at around 5,140 points, a monthly increase of 9%.

The exchange rate appreciated to almost $810 at the end of May but started June on a sustained upward trend, driven by both the weakening of copper (-3% so far this month) and the strengthening of the international dollar. This was reinforced by non-resident flows, which, in recent weeks, reversed the large bid for the Peso seen in late May. Thus, as this report was issued, the parity was hovering around $860 (+4% in June).

We expect the exchange rate to remain elevated until the end of the year due to a normalisation of copper prices towards trend levels (around US$4 per pound) and the global dollar strength due to the Fed's monetary normalisation, which is partially offset by the tightening of local financial conditions and a possible containment of political uncertainty after the constitutional process referendum.

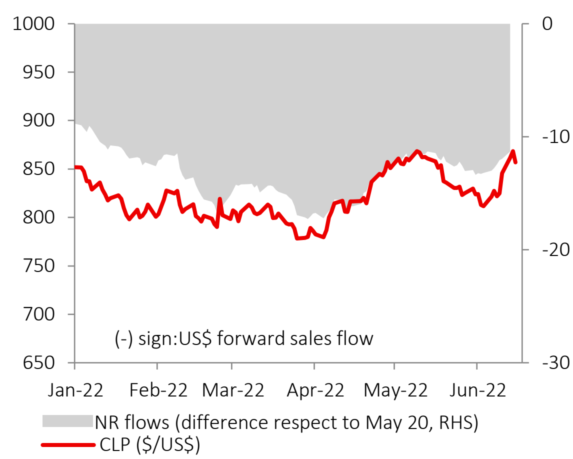
Furthermore, the bond market has continued to deepen the inverted yield curve. As a result, short-term rates rose, betting on further MPR hikes until well into the third quarter (1-year swap rate: 10%), while nominal long-term rates have seen some reversals (BTP10: 6.6%; -13bps and BTP5: 6.6%; -36bps) viewing a substantial economic slowdown. Long-term UF rates, by contrast, are rising on expectations of lower inflationary data in the medium term (BTU10: 2.2%; 6 bps and BTU5: 1.9%; 7 bps).

Risky assets retreat as investors seek safety in the dollar



Source: Bloomberg and Santander

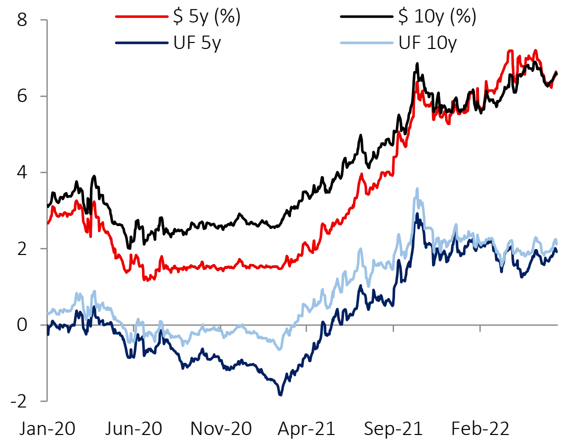
The flow of dollar sales declines



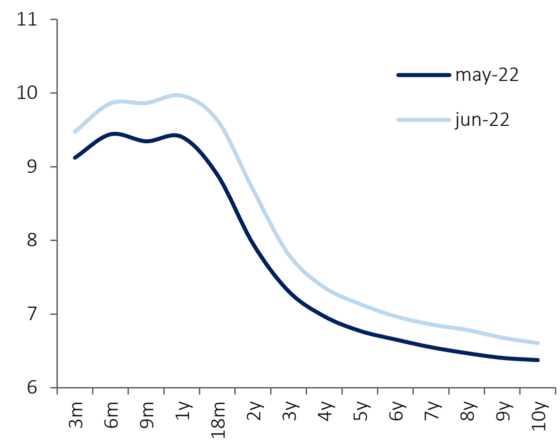
Source: Bloomberg and Santander

Long-term rates decline amid weaker economic prospects

The return curve widens its gap



Source: Central Bank, RiskAmerica and Santander.



Note: Based on swap rates.
Source: Bloomberg and Santander

Inflationary pressures remain high

Although the CPI for May (1.2% MoM) was within expectations, the figure still reflects strong and widespread inflationary pressures. Underlying indicators remain elevated (CPI excluding volatiles: 0.9%; CPI sans food and energy: 1%), and the diffusion index - which measures the percentage of items prices in the basket rising month-on-month - remains well above historical averages.

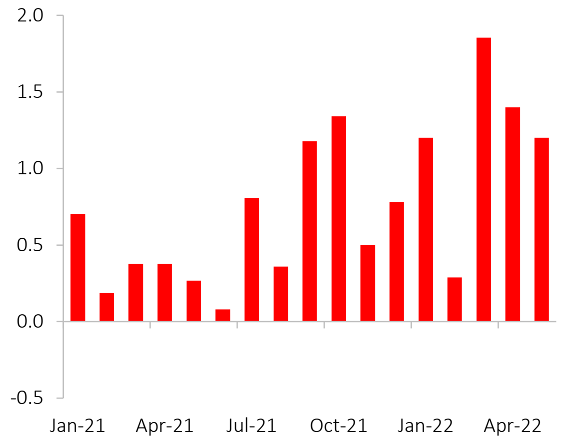
With May's figures, inflation rose to 11.5% YoY, its highest level in 28 years. In a breakdown by component, the Food division leads the way (17.1% YoY) with an incidence of 3.5%, accounting for nearly one-third of the annual CPI variation. Nonetheless, second-round effects on prices have already been evident, as reflected by further substantial increments in the Restaurants and Hotels division (1.4% MoM in May; 16.5% YoY).

In turn, widespread increases continue to be observed in most items linked to the exchange rate, particularly new cars (1.1%), furniture (1.9%), household cleaning products (0.8%), and recreational items (2.2%), while on the side of relevant decreases are mobile phones (-3.4%) and car parts (-1.9%).

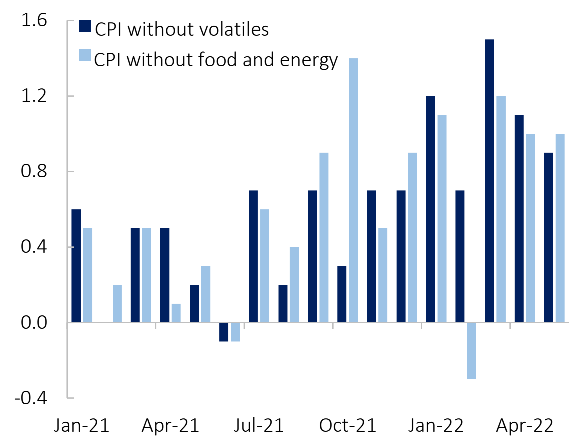
In the short term, prices will continue to be pressured up, particularly by further rises in oil and fuel prices in the global markets. Hence, the annual change in the CPI could rise to around 12.5% in June. However, in the second half of the year, the slowdown in the economic activity, a weak labour market and moderation in international prices will cause a gradual descent in inflation. Nevertheless, we estimate it would end the year at around 10%.

CPI rises more than 1% monthly for the third consecutive month

Underlying figures remain high



Source: National Institute of Statistics, Central Bank and Santander



Source: National Institute of Statistics, Central Bank and Santander

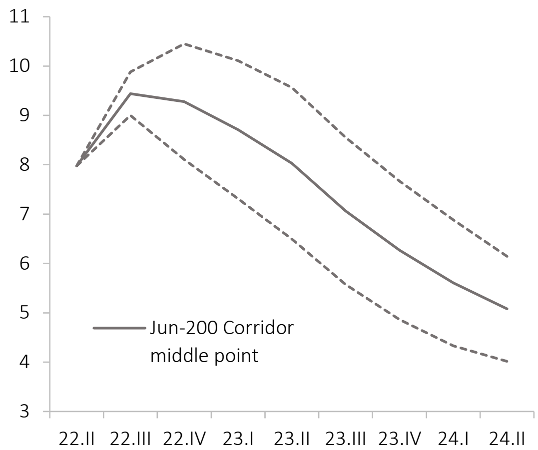
The rate hike cycle could be nearing its end

At its June Monetary Policy Meeting, the Central Bank Board raised the Monetary Policy Rate (MPR) by 75 bps, in line with expectations. This brought it to 9%, its highest level since the MPR nominalisation process began in mid-2001. Additionally, the Central Bank stated in the Monetary Policy Report its significant upward revision in the inflation projection (from 5.6% to 9.9% by December 2022) and adjusted the MPR corridor upwards. Both decisions did not surprise the markets, which had already noted the change in the Central Bank's stance after the inflationary surprise in March.

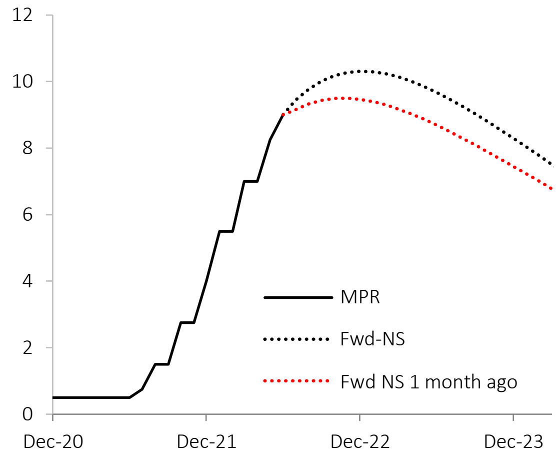
The new MPR corridor aims at a final rate of around 9.5% during the third quarter of this year. This suggests that the next Monetary Policy Meeting in July could entail an additional 50 bps hike, corroborating more moderate rate movements. At the early September meeting, the Board is expected to have inflation and activity data available that would already evidence a moderation, which could lead to a pause in the rate hikes. Therefore, the next monetary policy meeting hike in July could be the last in this cycle. Towards the end of the year, evidence of a further deterioration in activity and a moderating outlook for prices would allow the Board to start discussing rate cuts.

The Monetary Policy Report significantly corrects the rate corridor

The market points to prolonged maintenance of the MPR at high levels.



Source: Central Bank and Santander



Source: Bloomberg, Central Bank and Santander

National Accounts	2016	2017	2018	2019	2020	2021	2022 P	2023 P
GDP (real var. % YoY)	1.8	1.4	4.0	0.8	-6.0	11.7	1.5	0.5
Domestic demand (real var. % YoY)	1.9	2.9	5.0	1.0	-9.3	21.6	-0.3	-1.2
Total consumption (real var. % YoY)	4.1	3.8	3.6	0.7	-7.2	18.2	0.0	-0.5
Private consumption (real var. % YoY)	3.3	3.6	3.8	0.7	-8.0	20.3	-0.4	-0.8
Public consumption (real var. % YoY)	7.6	4.7	3.1	0.5	-4.0	10.3	1.7	-0.4
Gross fixed capital formation (real var. % YoY)	-2.4	-3.3	6.5	4.7	-9.3	17.6	-2.0	-1.5
Exports (real var. % YoY)	0.6	-1.0	4.9	-2.5	-1.1	-1.5	1.1	1.4
Imports (real var. % YoY)	1.2	4.5	8.6	-1.7	-12.7	31.3	-4.4	-4.5
GDP (US$ billion)	249.5	276.5	296.0	279.0	253.5	316.8	320.7	330.5
GDP per capita (US$ thousand)	13.7	15.0	15.8	14.6	13.0	16.1	16.2	16.5
Population (million)	18.2	18.4	18.8	19.1	19.5	19.7	19.8	20

Payment Balance	2016	2017	2018	2019	2020	2021	2022 P	2023 P
Trade balance (US$ billion)	5.0	7.5	4.4	3.0	19.0	10.6	11.3	10.9
Exports (US$ billion)	60.8	68.9	74.8	68.8	73.1	94.7	96.9	91.0
Imports (US$ billion)	55.8	61.4	70.4	65.8	55.1	84.1	85.6	80.1
Current account (US$ billion)	-6.5	-7.6	-13.3	-14.5	-4.3	-20.3	-11.7	-12.1
Current account (GDP%)	-2.6	-2.8	-4.6	-5.2	-1.7	-6.6	-3.6	-3.7
Copper price (annual average US$/lb)	2.2	2.8	3.0	2.7	2.8	4.2	4.4	4.2
WTI oil price (annual average US$/bbl)	43.2	50.9	64.8	57.0	39.0	68.0	100.0	91.0

Money and Exchange Market	2016	2017	2018	2019	2020	2021	2022 P	2023 P
CPI Inflation (var. YoY % up to December)	2.7	2.3	2.6	3.0	3.0	7.2	9.0	4.6

CPI Inflation (var. YoY % average)	3.8	2.2	2.4	2.3	3.0	4.5	10.0	5.6
CPI sans food and fuel inflation (IPC-SAE) (var. YoY % up to December)	2.8	1.9	2.3	2.5	2.6	6.4	6.0	4.2
CLP/US$ exchange rate (annual exercise)	667	615	696	745	711	852	850	860
CLP/US$ exchange rate (year average)	677	649	640	703	792	759	835	855
Monetary policy rate (%, year average)	3.5	2.5	2.8	1.8	0.5	4.0	9.5	5.8
Monetary policy rate (%, year average)	3.5	2.7	2.5	2.5	0.8	1.2	8.3	7.4

Fiscal Policy	2016	2017	2018	2019	2020	2021	2022 P	2023 P
Public expenditure (real var. % YoY)	3.8	4.8	3.5	4.1	11.0	31.6	-25.7	2.1
Central Government balance (% GDP)	-2.7	-2.8	-1.7	-2.9	-7.3	-7.3	-2.0	-3.0
Central Gov. gross Debt (US$ billion)	53.4	68.9	70.2	74.4	91.6	102.0	125.1	135.5

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