Prices start to moderate

Surprising October CPI and new evidence of demand contraction open the possibility that the Central Bank will begin the cycle of rate cuts in the Monetary Policy Meeting in January.

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Highlights

- **Global inflation remains high and monetary authorities have continued raising benchmark rates.** Regardless, financial markets have rallied at signs of a possible break in the inflationary trend, which could lead to an early end to the rate hike cycle.

- **Global activity slows down less than expected in the third quarter**. Nevertheless, indicators are marginally negative. The global economic outlook deteriorated further in October, reflecting the impact of the extension of the war in Europe and more adverse financial conditions.

- **Despite the annual contraction, local activity surprised again on the upside in September (0.2% MoM, -0.4% YoY).** Nonetheless, the steep fall in imports and car sales in October suggests a sharper contraction in the last months of the year. Thus, we maintain our growth estimate for 2022 at around 2.3%, and at -1.2% for 2023.

- **The labour market continues deteriorating.** There was a net destruction of jobs in September, with a sharp fall in formal employment. The unemployment rate rose to 8%, and new job vacancy levels remain low. In this context, real wages have continued to fall month on month, affected by the inflationary shock.

- **The October CPI (0.5%) surprised with an increase well below expectations.** The annual change declined to 12.8% for the second consecutive month, confirming a turnaround in the inflation trend. The weakness of the local economy and the adjustment in international prices will lead to moderate increments in the coming months, ending 2022 at around 12.3%. Therefore, we revise down our inflation projection to 5.3% for 2023.

- **Local assets recover at the increased global risk appetite and the unexpected downward movement in the CPI**. The exchange rate appreciated to levels close to $910, and long-term rates have responded with significant declines. Notwithstanding, important risks associated with the external environment and local political developments remain.

- **Surprising inflation data and the prospect of a more intense slowdown in activity raise the possibility of an MPR cut in January.** Over the next year, as inflation declines, the Council should rapidly reduce the MPR to support activity recovery in the run-up to 2024.

Global markets anxious for signs of moderation in rate hikes

Inflationary records of leading economies remain elevated, and major central banks have continued to tighten monetary conditions, with 75 basis point hikes to the benchmark rates of the Fed, the ECB and the Bank of England in the past month. In the case of the Fed, after a dovish reading of the last FOMC statement, the corroboration by Chairman Jerome Powell that the terminal rate of the hiking cycle would be higher than contemplated in September caused market expectations for the Fed Funds Rate to move upwards, peaking at 5% in early 2023. Despite this, financial markets tended to rally on signs of a possible break in the inflationary trend that could lead to an early end to the rate hike cycle.

The global MSCI index rose by almost 8% in the month, led by the US and the Eurozone, whose stock indices climbed by around 10%. Emerging markets and Latam stock markets also rose strongly (4% and 8%, respectively), and volatility declined (VIX: -7 points). Moreover, increased risk appetite caused the dollar to depreciate by about 3% in multilateral terms and commodity prices to rise (aggregate index: +2%), with energy (+2%) and metals (+5%) components standing out. Nevertheless, despite the mixed movements, long-term rates remained high, particularly in the US (Q10 above 4.1%).

At the time this report was issued, markets were awaiting the US October inflation figure. The annual change in total CPI is expected to fall from 8.2% to 7.9%, its fourth consecutive decline since the peak of 9.1% in June. While this would be a good sign, the underlying component will be the key element to monitor in determining a possible change in the Fed's bias.

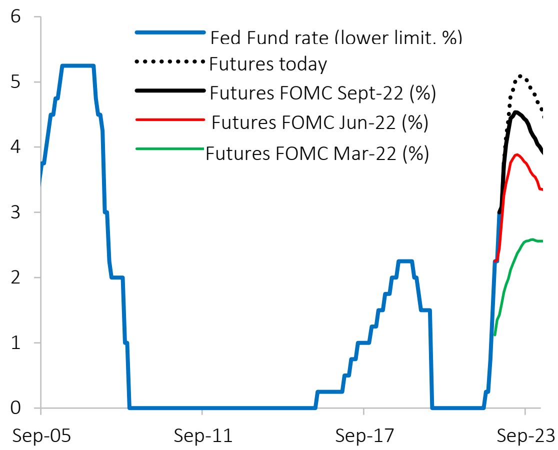
In the meantime, the US labour market remains robust, with strong job creation in October (non-farm payrolls: 261k vs 193k expected; ADP private employment: 239k vs 185k expected) and unemployment claims still at low levels (around 220k). Despite the above, the unemployment rate rose to 3.7% due to higher labour participation. Activity has shown mixed signals. On the one hand, 3Q22 GDP came in above expectations (2.6% QoQ vs 2.4% expected), led by a still dynamic consumption (1.4% vs 1% expected). On the other hand, September's industrial and durable goods orders showed very limited increments (0.3% and 0.4%, respectively) and October PMIs, although somewhat above expectations, moved back into more contractionary territory (composite index: 48.2 vs 49.5 the previous month).

On the political front, the mid-term elections captivated investors' attention, given the renewal of the entire House of Representatives, one-third of the Senate and a large number of state governors. Against forecasts, the Democratic party is expected to perform well and maintain control of the Senate. Republicans, meanwhile, could win control of the House of Representatives, but that is not enough to pave the way for a return to the White House. Therefore, it is not clear that Donald Trump will announce his nomination on November 15, as expected.

In Europe, activity in the third quarter decelerated somewhat less than expected (3Q22 GDP: 2.1% YoY vs 4.1% previously), but October PMIs were in a contractionary territory (manufacturing: 46.4; services: 48.6). Europe remains subject to a severe energy crisis due to the conflict in Ukraine, the resolution of which is still far off, which is likely to impact economic activity in the coming quarters.

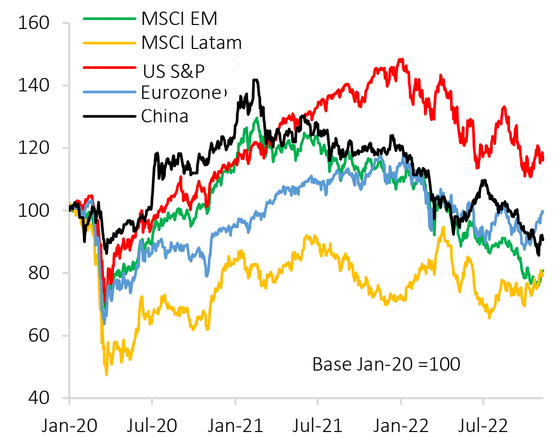
In China, after the upward surprise of 3Q22 GDP (3.9% YoY vs 3.3% expected), October's foreign trade figures disappointed (exports: -0.3% YoY vs +4.5% expected; imports: -0.7% YoY vs 0% expected) and Caixin PMIs for the month remained below the 50 threshold. This reflected the weakness observed in its domestic demand beyond the effects of the zero-tolerance Covid policy.

Powell's hawkish bias raised rate hike expectations



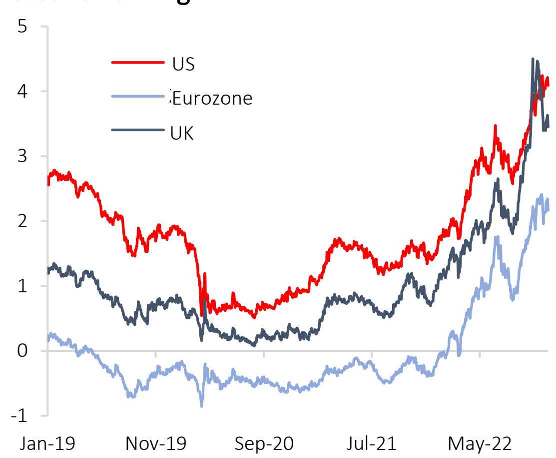
Source: Bloomberg and Santander

Stock indices recover in the last month, except for China



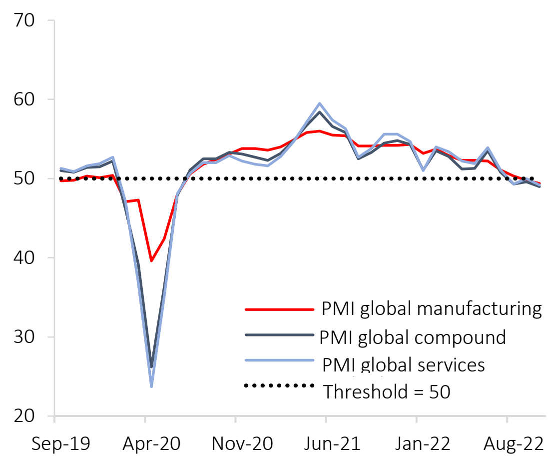
Source: Bloomberg and Santander

Although with mixed movements, long-term rates remain high



Source: Bloomberg and Santander

The global economic outlook deteriorated further in October



Source: Bloomberg and Santander

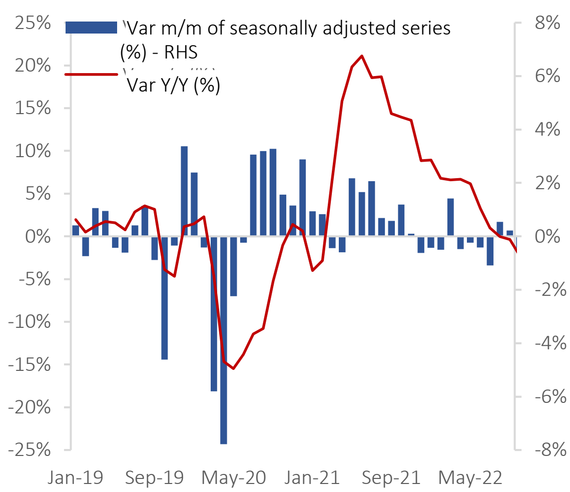
Despite a better performance in September, local activity will close the year with a significant decline

As expected, the September Imacec was the first negative figure since the pandemic's beginning (-0.4% YoY). Nevertheless, the figure was above market estimates (Bloomberg: -1.1%; Santander: -0.6%), and the monthly change was positive for the second consecutive month (0.2% MoM seasonally adjusted). In addition, manufacturing (1.5% MoM seasonally adjusted), services (0.4% MoM seasonally adjusted) and trade rose strongly after four consecutive months of declines (0.8% MoM seasonally adjusted). Beyond some one-off effects, these data showed that, despite the significant adjustment shown by consumption so far, it has been somewhat less intense than estimated until some time ago.

Nevertheless, the partial figures for October point to a significant contraction in activity. Imports for the month recorded a significant decline (-13.3% YoY), with significant drops in consumer goods and items related to inventory rebuilding, new vehicle sales fell back to levels not seen since early 2021 (-25.7% YoY). In addition, the monthly Business Confidence Indicator (IMCE) declined again (39 October vs 43.3 September). This points to a monthly decline in the October Imacec, which we estimate at just over 0.4%, bringing its annual change down to -2.5%.

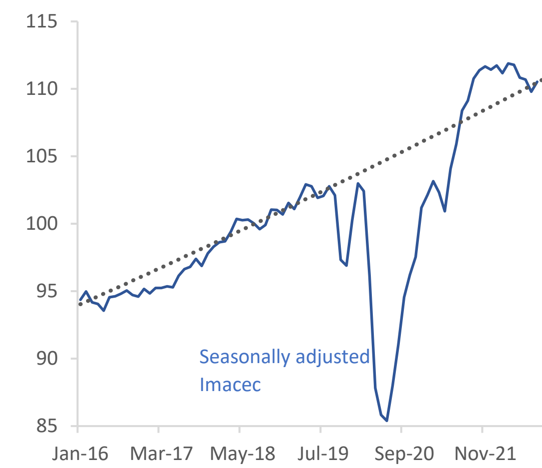
For the year, we maintain our projection of growth of around 2.3% and -1.2% for 2023. Thus, a negative activity gap will emerge already in the fourth quarter of this year and will remain open for several quarters.

Despite the annual decline, September Imacec is slightly above expectations



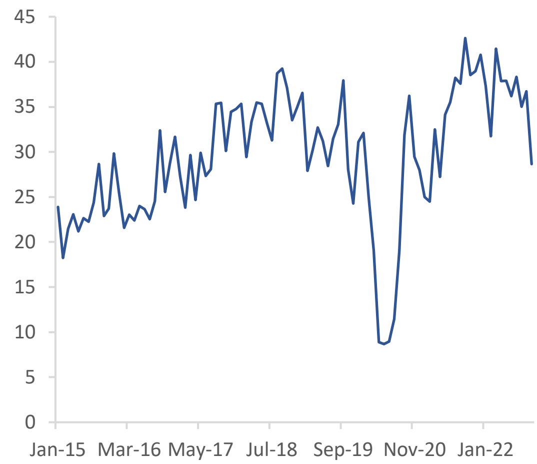
Source: Central Bank

The level of activity is around trend



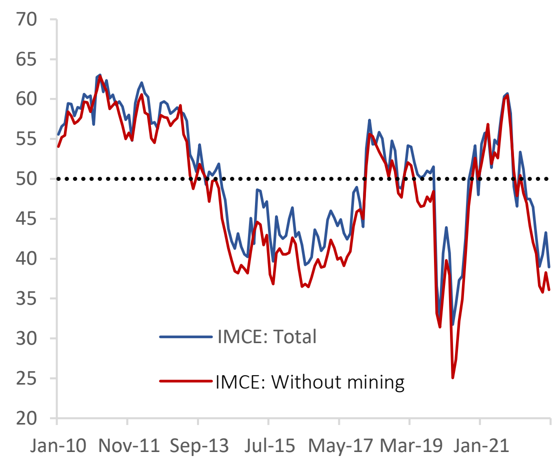
Source: Central Bank and Santander

Sharp drop in new car sales in October



Source: Central Bank

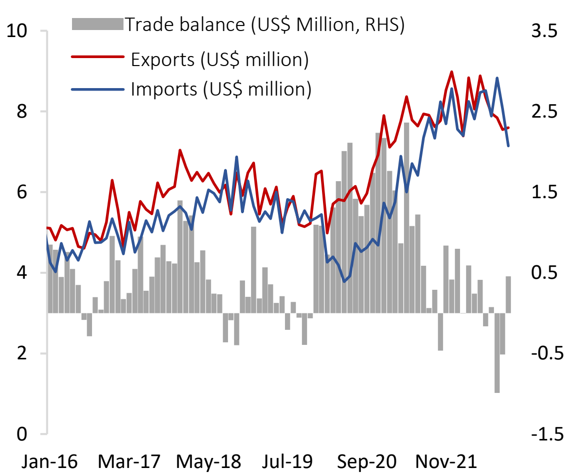
Business expectations fall back after the rebound in September



Source: Central Bank and Santander

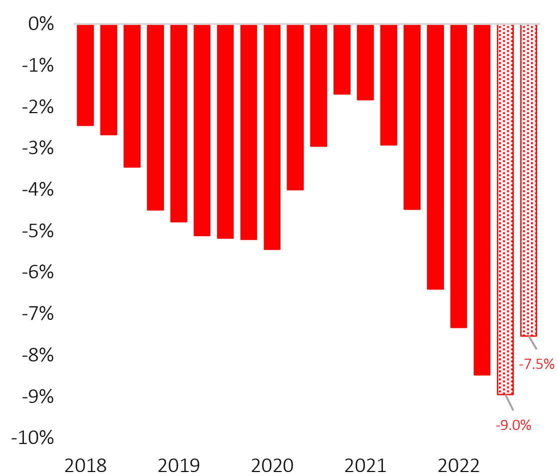
As we have noted in previous reports, the current account deficit widened further in the third quarter, to 9% of GDP on a rolling year basis, due to the strength of imports until a few weeks ago and the drastic decline in the value of exports due to the fall in the copper price. In the fourth quarter, though, we will see a substantial correction due to the adjustment in imports that started to be seen in October. This reflects the expected contraction in domestic demand in the face of the monetary and fiscal tightening. Thus, we estimate the year will close with a current account deficit close to 7.5% of GDP. Admittedly, this is a high figure by historical standards, but it is important to note that it has been financed by liquidating financial assets and not by increased external debt.

Trade balance returns to surplus in October after a sharp fall in imports



Source: Central Bank and Santander

The current account deficit will widen again but will close the year at around 7.5% of GDP



Source: Central Bank and Santander

The labour market continues to lose momentum

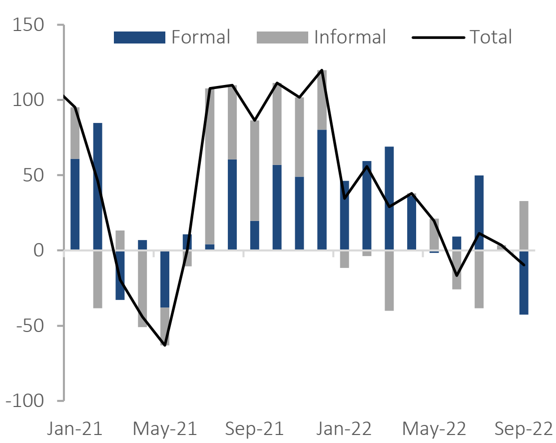
The moving quarter ending in September concluded with a net destruction of 9.7 thousand jobs, with a fall of 42 thousand formal jobs partially offset by an increase of 33 thousand informal jobs. This increased the unemployment rate to 8%, the highest in a year, even though the labour participation rate (59.7%) is still well below its pre-pandemic levels. If it were at historical values, the unemployment rate would be considerably higher, at around 12.5%.

On the other hand, the demand for labour also remains weak. After falling sharply in September, the Central Bank's job vacancy index slightly recovered in October but remains well below the levels observed until a few months ago. In the same line, September figures from SENCE's labour observatory (SABE) showed a monthly drop in published vacancies of 18.5%.

In this context, real wages have continued to deteriorate, affected by the inflationary shock. Thus, the INE's real compensation index decreased by 0.4% MoM in September, its eighth consecutive monthly decline. This brought its annual change to -2.3%.

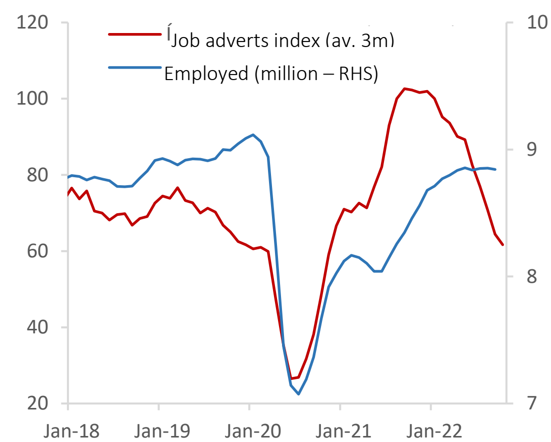
In the future, as economic activity continues to deteriorate, demand for labour will remain on a downward trend, dampening job creation. The labour force, meanwhile, is likely to extend its recovery gradually. If this happens, the unemployment rate will continue to rise in the coming months.

Job creation stagnates, with formal jobs falling sharply...



Source: Central Bank and Santander

...while demand for labour remains subdued



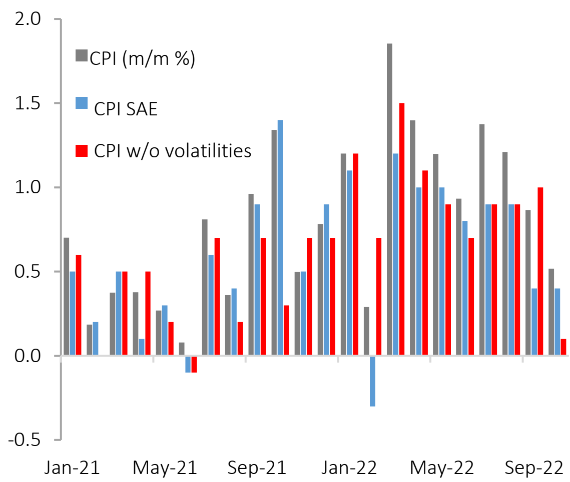
Source: Central Bank and Santander

Surprising October CPI reaffirms inflation trend reversal

The October CPI (0.5%) was well below market estimates (Bloomberg: 0.9%; Santander: 0.9%), weighed down by large falls in the prices of durable and semi-durable goods (new cars, furniture and clothing). Thus, the CPI for goods showed a zero change, the smallest since June 2021, while the CPI for services rose 1.1%, driven by transport services. Core inflation, as measured by the CPI excluding food and energy (CPI SAE), rose by 0.4%, while the CPI excluding volatility rose by only 0.1%, its smallest increase since mid-2021. This brought the annual change in the CPI down to 12.8%, the second consecutive month of decline. Furthermore, the annual change of the CPI SAE fell to 9.3% and the non-volatile CPI to 10.8%.

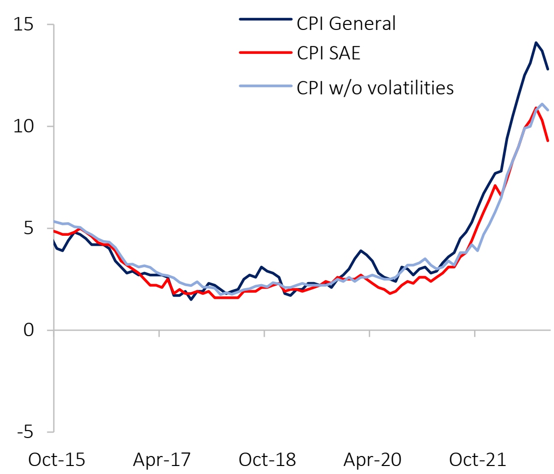
The October data showed a clear reduction in price pressures. The inflation diffusion index declined sharply and settled around its historical averages. Of note was that goods prices – particularly durable and semi-durable goods – fell while the exchange rate trended upwards during the month (+3.8%). This reflects a tightening of marketing margins due to weakening demand. The most obvious case is that of cars, where the decrease in prices in October (-3.4% MoM) coincided with a sharp decline in sales (-21% MoM, according to ANAC).

October CPI surprises on the downside



Source: National Institute of Statistics and Santander

Inflation begins to recede

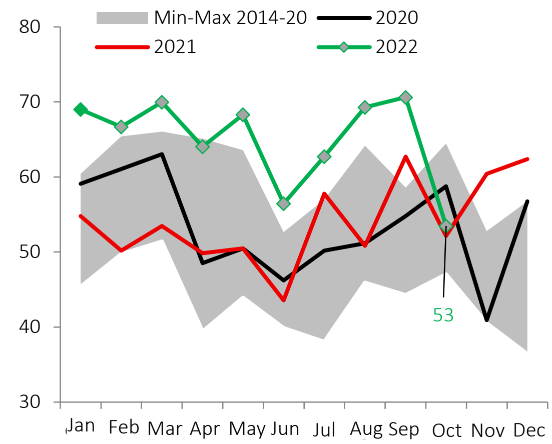


Source: National Institute of Statistics and Santander

We expect CPI changes to remain moderate in the future as local economic activity continues to lose steam and international prices normalise. Concerning the latter, the fall in maritime freight costs, which are already at levels similar to those prevailing before the pandemic, is noteworthy.

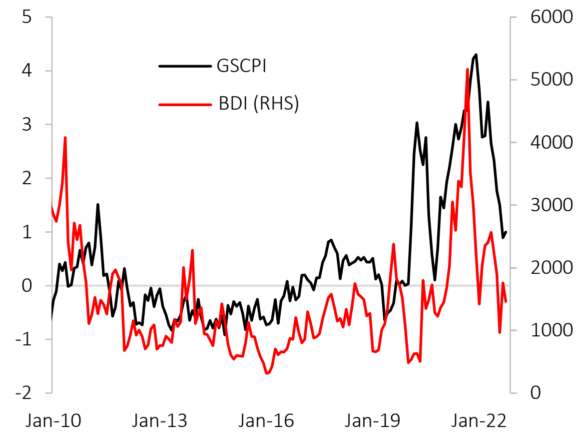
For November, we expect the CPI to increase moderately by around 0.5%. With this, the annual change in the index will remain at around 12.8% before falling back in December, where we expect inflation to close the year at around 12.3%.

The low inflationary diffusion shows that price pressures have moderated.



Source: National Institute of Statistics and Santander

Maritime freight costs return to pre-pandemic levels



Source: National Institute of Statistics and Santander

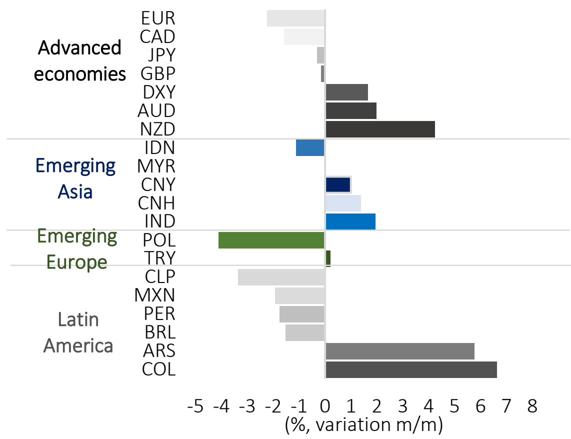
Local financial assets rebound

Increased risk appetite globally, and a significant moderation of inflation in Chile, led to a rise in local asset prices. Long-term rates have fallen by more than 40 basis points since mid-October (BTP10: 6% and BTU10: 2.1%), and the stock rose to 5,350 points (7.9%), outperforming the returns of its peers in the region. The exchange rate, meanwhile, appreciated by more than 3% in the month, closing slightly above $900. This was influenced not only by the global depreciation of the dollar and the rise in copper prices to US$ 3.7 per pound (6.6% in the month) but also by the fact that non-resident investors resumed their positions in emerging markets.

Despite the above, risks remain. On the one hand, the process of international rate hikes is not over, and there is the possibility that the Fed may need to tighten monetary policy if inflation continues to surprise on the upside. Should this be the case, local assets could see a new round of falls. On the other hand, a more pronounced slowdown in China could push down the price of copper, with a consequent depreciatory impact on the local currency. The risks of the local political scene are added to this.

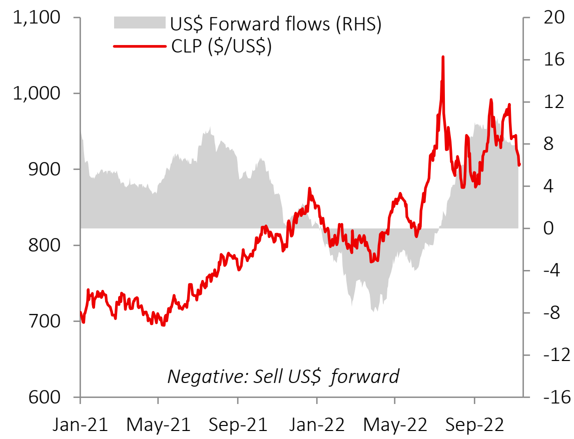
Nevertheless, the government's announcement of the main axes of the pension reform partly cleared up uncertainty regarding developments in the capital market. The proposal maintains the system of individual capitalisation at 10.5% of taxable income, which – together with raising the income ceiling – could increase households' long-term savings and maintain the flow of financing for companies. The legislative discussion that will follow will be crucial in determining the ultimate impacts of this reform.

Strong appreciation of the local currency



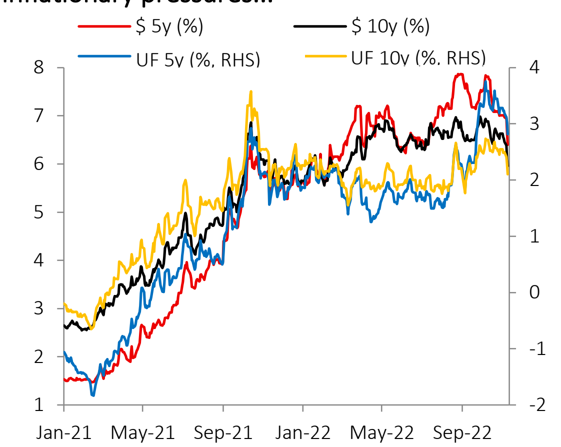
Source: Bloomberg and Santander

Non-resident investors resume positions in favour of the Peso



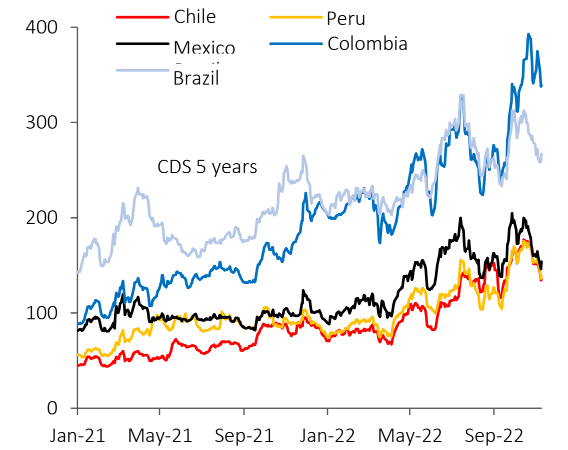
Source: Bloomberg and Santander

Long-term rates fall sharply on easing inflationary pressures...



Source: Bloomberg and Santander

...and favourable development of the sovereign risk premium



Source: Bloomberg and Santander

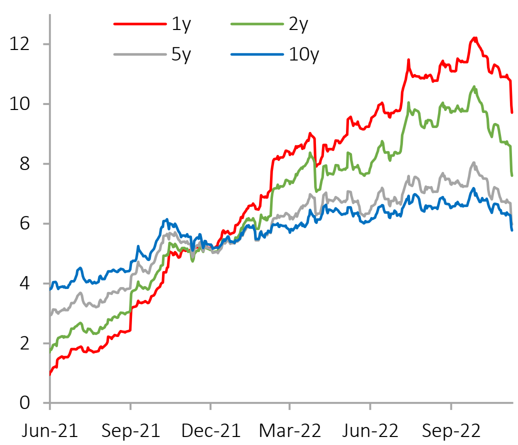
Rate cut could begin in January Monetary Policy Meetings

As anticipated, the Central Bank ended the rate hike cycle at its Monetary Policy Meeting on October 12 with a 50 bps hike that drove the MPR to 11.25%. The data known since then – with the moderation of the CPI and the annual fall in activity – confirm that there will be no further increments and that the next move in the rate would be a cut.

We estimate that at the next Monetary Policy Meeting in December – which coincides with an IPoM– the Council will leave the rate unchanged and outline the strategy for initiating MPR reductions during 2023. While in our most likely scenario, this will occur at the April Monetary Policy Meeting when there is greater certainty of normalisation of inflation, the latest data open the possibility that the first cut will occur at the January Monetary Policy Meeting. By then, inflation figures for November and December will be available, which should confirm a moderation in prices, and the Imacec for October and November, which will show a sharper contraction in activity and anticipate a fall in GDP in 2023. Considering that monetary policy acts with lags and that decisions taken in early 2023 will impact the following year, this could lead the Council to decide to lower the rate in January by 25-50 basis points.

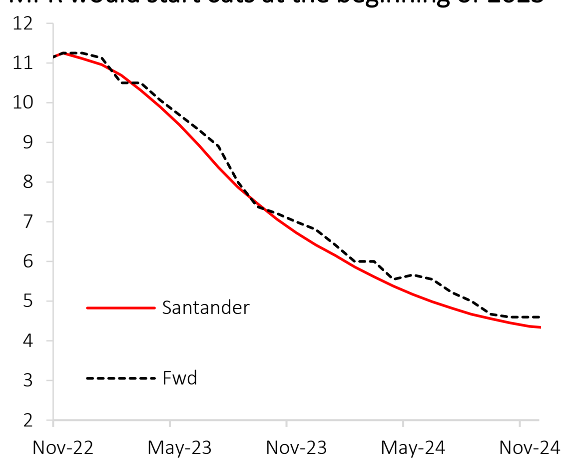
This moderate reduction would allow testing the response of the exchange market to a desynchronisation of the monetary cycle between Chile and the major markets. Then, the cuts would be greater from the April Monetary Policy Meeting onwards, and the MPR would close the year at around 6.5%. Market rates point to a somewhat more aggressive start, with an MPR cut of 75 basis points in January, before continuing a path similar to our trajectory.

Swap rates fall in anticipation of future policy rate cuts



Source: Bloomberg and Santander

MPR would start cuts at the beginning of 2023



Source: Bloomberg 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	2.25	-1.2
Domestic demand (% real var. YoY)	1.9	2.9	5.0	1.0	-9.3	21.6	2.5	-3.4
Total consumption (% real var. YoY)	4.1	3.8	3.6	0.7	-7.2	18.2	2.8	-3.1
Private consumption (% real var. YoY)	3.3	3.6	3.8	0.7	-8.0	20.3	2.3	-4.4
Public consumption (% real var. YoY)	7.6	4.7	3.1	0.5	-4.0	10.3	4.9	2.0
Gross fixed capital formation (% real var. YoY))	-2.4	-3.3	6.5	4.7	-9.3	17.6	-1.9	-4.4
Exports (% real var. YoY)	0.6	-1.0	4.9	-2.5	-1.1	-1.5	0.9	1.3
Imports (% real var. YoY)	1.2	4.5	8.6	-1.7	-12.7	31.3	1.9	-6.2
GDP (US$ billion)	249.5	276.5	296.0	279.0	253.5	316.8	302.0	298.0
GDP per capita (US$ thousand)	13.7	15.0	15.8	14.6	13.0	16.1	15.3	14.9
Population (million)	18.2	18.4	18.8	19.1	19.5	19.7	19.8	20.0

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	10.5	2.4	6.2
Exports (US$ billion)	60.8	68.9	74.8	68.8	74.1	94.7	96.4	86.1
Imports (US$ billion)	55.8	61.4	70.4	65.8	55.1	84.1	94.0	79.9
Current account (US$ billion)	-6.5	-7.6	-13.3	-14.5	-4.3	-20.3	-22.8	-12.0
Current account (% GDP)	-2.6	-2.8	-4.6	-5.2	-1.7	-6.6	-7.5	-4.0
Copper price (year average US$/lb)	2.2	2.8	3.0	2.7	2.8	4.2	3.9	3.6
WTI oil price (year average US$/bbl)	43.2	50.9	64.8	57.0	39.0	68.0	95.0	78.0

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	12.3	5.3
CPI Inflation (% var. YoY average)	3.8	2.2	2.4	2.3	3.0	4.5	11.6	7.9
CPI Inflation excluding food and energy (IPC-SAE) (% var. YoY up to December)	2.8	1.9	2.3	2.5	2.6	6.4	8.6	5.5
CLP/US$ exchange rate (year end)	667	615	696	745	711	852	950	960
CLP/US$ exchange rate (year average)	677	649	640	703	792	759	881	955
Monetary policy rate (% year end)	3.5	2.5	2.8	1.8	0.5	4.0	11.25	6.50
Monetary policy rate (% year average)	3.5	2.7	2.5	2.5	0.8	1.2	8.6	9.0

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	-24.0	4.2
Central Government balance (% GDP)	-2.7	-2.8	-1.7	-2.9	-7.3	-7.7	1.6	-2.7
Central Gov. gross Debt (US$ billion)	53.4	68.9	70.2	74.4	91.6	102.0	108.7	114.0

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