Concern about global recession lowers commodity prices

Reduced oil and grain prices will allow global inflation to start receding. Nevertheless, rates will continue to rise in the short term.

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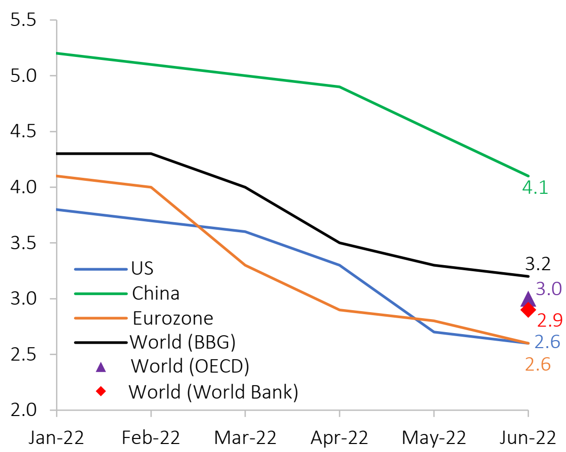
Highlights

- **Activity data for the leading economies remain mixed.** Nevertheless, the impact of tightening financial conditions, the effects of the war in Ukraine and the sharp slowdown in China have raised fears of a global recession.
- **Global inflation remains high.** The CPI data for June in the US (9.1%) and Europe (8.6%) again surprised on the upside, anticipating that the rate hikes will continue in the short term.
- **Commodity prices decline sharply at prospects of weaker demand.** As of this report's issue, the price of copper had shrunk 25% below its mid-June levels, and oil was down by 15%. Grains have also dropped sharply, not only in reaction to a possible lower demand but also at the possibility of recovering shipments from Ukraine.
- **Local activity continues to lose momentum.** The non-mining Imacec for May recorded a significant drop, and available indicators for June suggest that this trend is likely to continue.
- **A US$1.2 billion fiscal aid package will help to moderate the consumption slowdown.** Overall, the favourable tax collection during the year's first months will curtail the public deficit to around 0.5% of GDP by the year's end.
- **Successful foreign exchange intervention by the Central Bank.** After the local currency had strongly lost value in recent weeks at the fall in copper prices, the global strengthening of the dollar and short-term speculative movements, a liquidity injection of up to US$25 billion caused the parity to align to its fundamentals at around $925.
- **Inflation will continue to rise in the short term.** Although the CPI for June was somewhat lower than expected, the CPI for the coming months will be higher due to the impact of currency depreciation and second-round effects. As a result, moderation should take place in the latter part of the year. Nevertheless, inflation will close in 2022 at around 12%.
- **The end of the MPR hike cycle is delayed.** At its last Monetary Policy Meeting, the Central Bank Board raised the rate somewhat higher than expected (75 bps) to 9.75%. As a result, a 50 bps hike is likely in September and in all likelihood, the cycle will likely culminate in October, with a further 25 bps increase. Then, early next year, the process of cutbacks could begin.

Recession fears intensify around the world

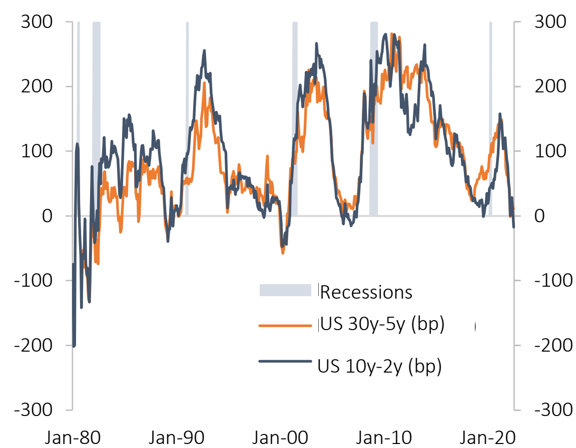
The global growth outlook has continued to correct downwards in recent weeks and is now below 3% (more than 1pp lower than at the beginning of the year). Several factors are behind this. In the case of the US, this includes the impact of the Fed's benchmark rate hike and higher inflation. In Europe, not only higher inflation has played a role, but also the disruptions caused by the war in Ukraine and, in particular, possible gas supply cuts from Russia. In China, there are confinements due to the "zero Covid" policy implemented by the authorities and the complexities facing its real estate sector following the tightening of the financial regulations imposed a couple of years ago. Against this background, it cannot be ruled out that the world will face a recession in the coming quarters, although, if it materialises, it should be moderate.

Global GDP in 2022 continues to correct downwards



Source: Bloomberg and Santander

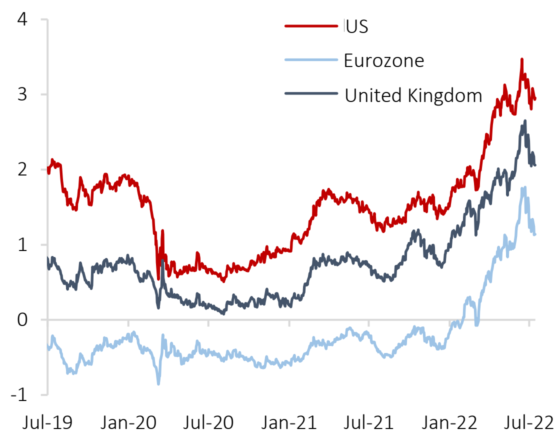
US yield curve inversion reveals recessionary fears



Source: Bloomberg and Santander

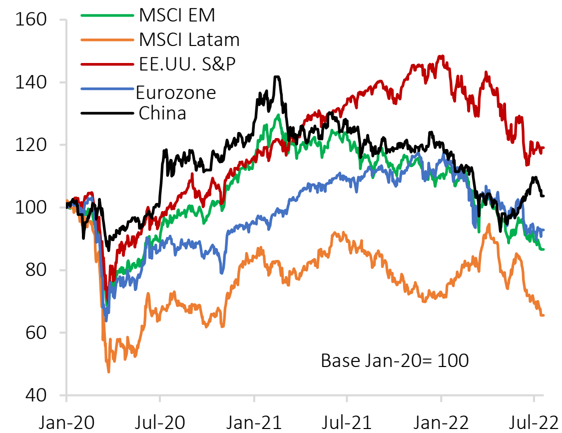
The tightening of financial conditions in the US has strengthened the multilateral dollar (+3%), which is at levels not seen in 20 years (DXY: 106 points). Furthermore, recessionary fears led to a significant fall of more than 40 bps in long-term interest rates. On the other hand, major stock markets declined during the month (MSCI global: -2%), and there was a sharp fall in commodity prices on prospects of weaker global demand (composite commodity index: -15%).

10-year interest rates fall sharply



Source: Bloomberg and Santander

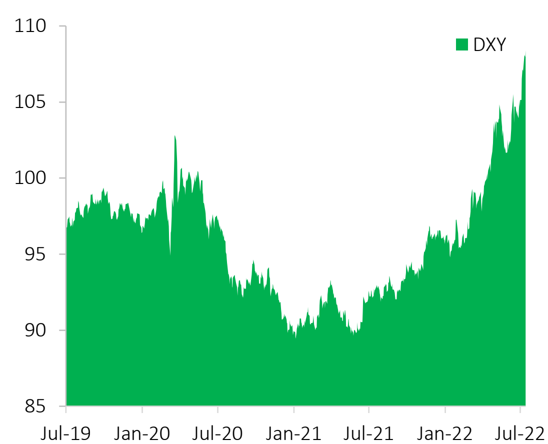
Global stock indices retreat



Source: Bloomberg and Santander

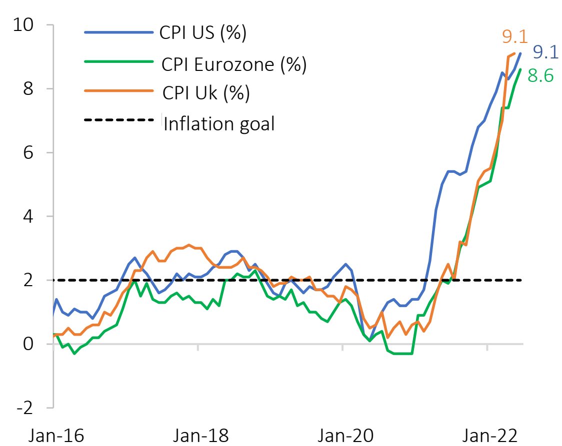
In the US, the CPI for June surprised again, raising the annual measure to a new decade peak of 9.1% (8.8% expected; 8.6% previous). Underlying components remained elevated (around 6% over twelve months), which - coupled with the still robust labour market figures (non-farm payroll employment: 372 thousand vs 265 thousand expected; unemployment rate: 3.6% for the third consecutive month) - reinforced expectations of an aggressive stance by the Fed at its meeting this month, with a further rate hike of at least 75 bps. Activity figures have provided mixed signals, with some upward surprises (industrial orders: 1.6% vs 0.5% expected; durable goods orders: 0.8% vs 0.7%; composite PMI: 52.3 vs 51.2 expected), but also with downward data (personal consumption 1Q22: 1.8% vs 3.1% expected; personal spending: 0.2% vs.0.4% expected in May).

Global dollar hits record high



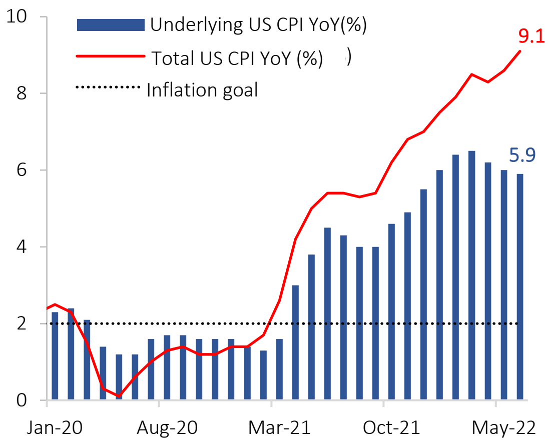
Source: Bloomberg and Santander

Inflation remains high around the world



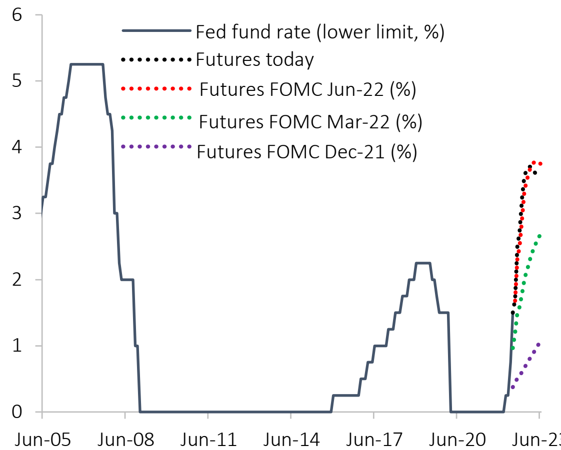
Source: Bloomberg and Santander

US CPI for June surprised again



Source: Bloomberg and Santander

Fed braces for another hike in July



Source: Bloomberg and Santander

The debate between economic weakening and inflationary persistence has dominated market sentiment in the Eurozone. Although some activity figures rebounded (industrial production: 1.6% YoY vs 0.3%; retail sales: 0.2% vs -0.3% expected), pessimism was noticeable in the latest expectations surveys for July (ZEW: -51.1 vs -28 previous; Sentix: -26.4 vs -15.8 previous).

As of the date this report was issued, the June inflation data was mixed. On the one hand, the total CPI rose to 8.6%, well above the 8.1% in May. On the other hand, underlying inflation eased slightly to 3.7% (3.8% previously). Nevertheless, markets have significantly increased the probability of a 50 bps rate hike by the European Central Bank on Thursday (instead of 25 bps). ECB President Christine Lagarde left the space open for a hike of more than 25 bps on 28 June by arguing that there are conditions under which gradualism would not be appropriate.

In China, June activity picked up due to the lifting of the previous two months' containment measures (Caixin composite PMI: 55.3 vs 42.2 previously; industrial production: 3.9% vs 0.7% previously; retail sales: 3.1% vs -6.7% previously). Nonetheless, the 2Q22 GDP figure disappointed, falling more than expected (-2.6% QoQ vs -2% expected, 1.3% previous). As a result, the annual measure of expansion was corrected downwards (0.4% vs 1.2% expected, 4.8% previous), the lowest since the start of the pandemic in 2020.

Sharp decline in commodity prices due to growing recession fears and dollar strength

Most major commodity prices, including energy, base metals and food, have experienced significant declines, reflecting the increased probability of a global recession and the strength of the dollar.

In particular, the copper price dropped to levels below US$3.2. This had not been observed since November 2020. Furthermore, the oil price fell to US$95 for WTI, its lowest since April this year.

In both cases, supply difficulties are apparent, which should moderate downward pressures, even in a global recession that would be of short and low intensity. Concerning copper, the world's two main copper producers (Chile and Peru) are experiencing problems. The former faced a significant decrease in production in the first half of the year due to lower ore grades, and the latter saw social unrest, which has resulted in blockades of mining sites and some arson attacks.

Regarding oil, meanwhile, OPEC's difficulties in increasing production are evident. At the same time, the effect of sanctions on Russia has meant a supply reduction in the order of two million oil barrels and refined fuels per day.

In the case of natural gas, the tense situation concerning Russia's supply to Europe – in which a recent 11-day shutdown of the Nordstream pipeline compounded with the Russian company Gazprom's force majeure default announcement to a key customer in Europe - has contributed to keeping gas prices high.

Concerning agricultural and food commodities, the case of wheat stands out, where better weather conditions in the northern hemisphere have facilitated earlier harvests. At the same time, Russia is in talks with Ukraine to export its grain through the Dead Sea ports. Both factors have pushed down the price of wheat as well as that of other grains.

That said, downward corrections in the price of a wide range of commodities should help moderate inflationary pressures. Nevertheless, it is worth noting that as of the date this report was issued, there has been some price recovery, with copper rising to the US$3.3 per pound level and oil prices exceeding US$100.

Local economy continues to slow down

Although the Imacec in May showed only a slight decline over April (-0.1% MoM seasonally adjusted) and its annual growth rate remained high (6.4%), the non-mining components showed a significant contraction (-0.9% MoM seasonally adjusted) after months of volatility around a constant level. The decline was driven by strong contractions in the trade sector (-2.3% MoM) and manufacturing (-1.5% MoM). Services also dropped, albeit moderately (-0.1% MoM). The "other goods" sector, which includes construction, showed a surprising marginal acceleration (1.4% MoM), although we estimate it to be transitory.

Employment in May maintained weak growth, with only 20,000 additional jobs created. These were led by women, while male employment saw a net loss of 2,000 jobs. This maintains a significant gap in the total level of employment over its pre-pandemic situation of close to 3%. On the other hand, the unemployment rate has increased moderately since April and reached 7.8%. Based on the historical labour participation rate, unemployment is still well above the pre-pandemic averages at around 12%.

Furthermore, real wages continued to be hit by inflation, despite growing by 9.6% over 12 months in nominal terms. Thus, adjusted by CPI, wages now have eight months of negative annual changes (-1.8% in May).

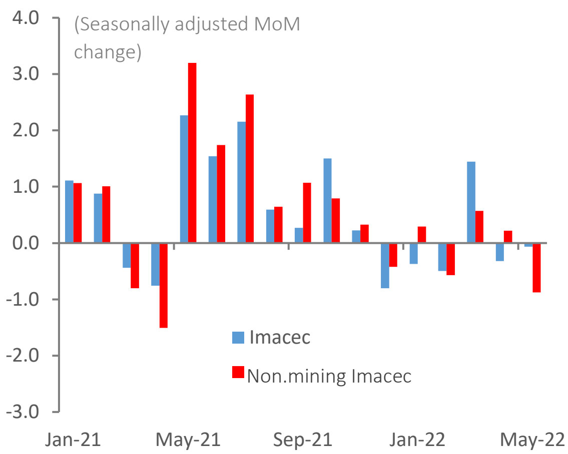
In June, some indicators showed that activity continued to lose momentum. The monthly Business Confidence Indicator (IMCE) dropped again, and imports of non-automotive durable goods plummeted (-29% MoM). Imports of capital goods also declined after the previous month's rise.

Regarding the labour market, the vacancy index calculated by the Central Bank decreased again, accentuating the downward trend of the last few months.

Based on these factors, we estimate that the Imacec for June would have contracted further on a monthly basis, and the annual growth would have been of around 3%. In the future, the comparison basis will start to be demanding. In addition to a fall in activity level due to tight financial conditions, high domestic political uncertainty and a worsening external scenario, the economy will show a significant contraction in the year's second half.

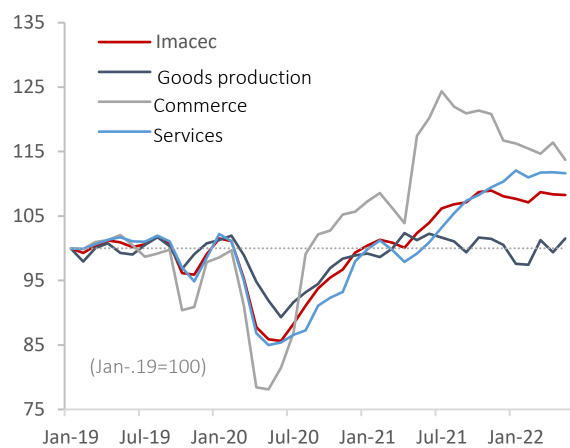
The announcement of a US$900 billion Bono Invierno (Winter Bond) will help contain the slowdown in consumption. Nevertheless, fiscal policy will remain contractionary this year. Thus, we maintain our projection of limited growth in 2022, at around 1.5%.

Imacec recedes in May due to a fall in the non-mining sector...



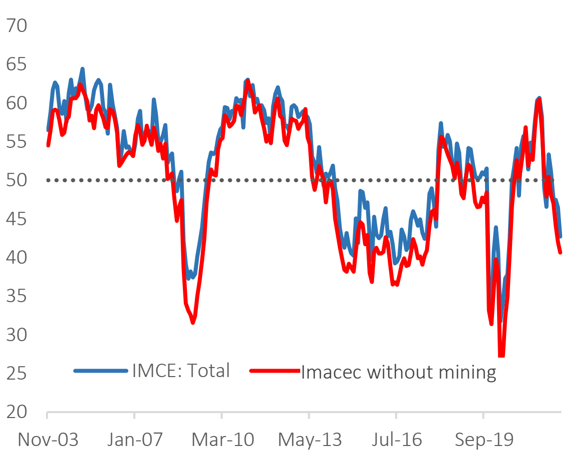
Source: Central Bank and Santander

... and trade is the sector showing the strongest contraction



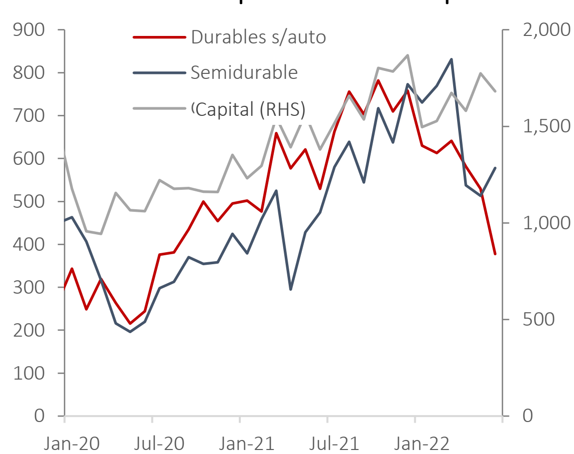
Source: Central Bank and Santander

Business confidence continues to decline



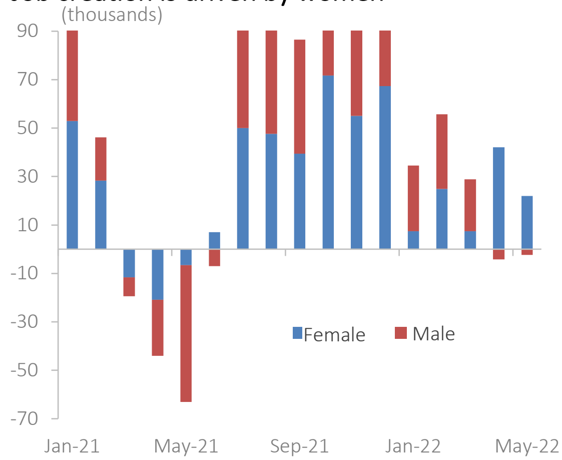
Source: UAI and Santander

Non-car durable imports continue to plummet



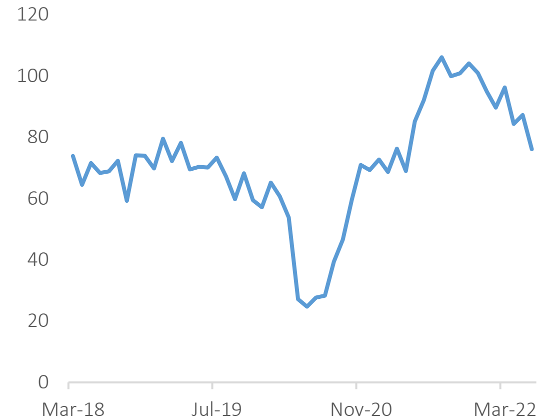
Source: Central Bank and Santander

Job creation is driven by women



Source: National Institute of Statistics and Santander

Vacancies decrease



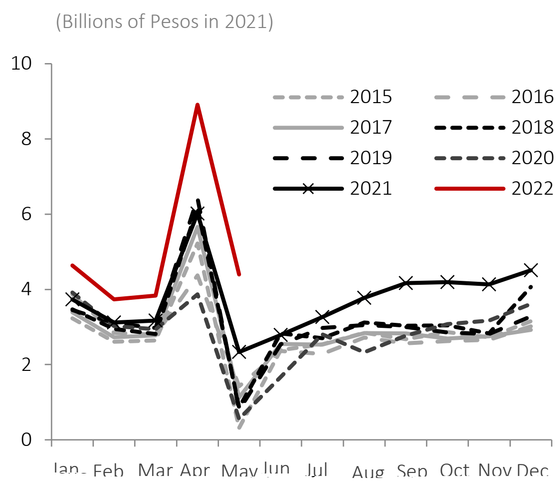
Source: Central Bank and Santander

Government's economic aid package will make spending contraction less intense

The announced aid package has an estimated cost of US$1.2 billion (around 0.4% of GDP). Among the measures, the extension of the IFE Laboral until the last quarter of the year and a "Bono Invierno" (Ch$120,000 for 7.5 million people) stand out. This new package, added to the previous one, increases government spending by US$ 5.151 billion (1.7% of GDP) over the budget. This would bring the projected fall for the year to 24.5%.

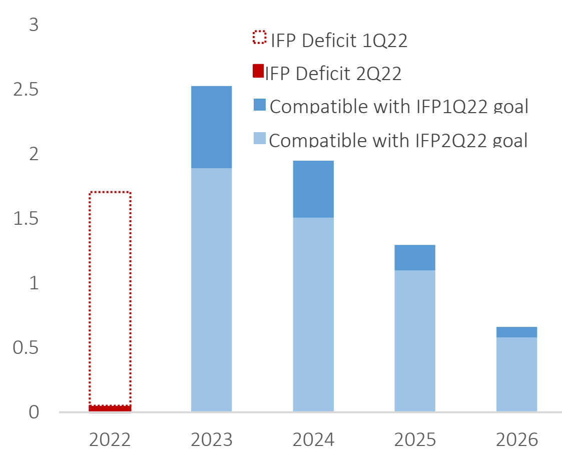
Revenues have grown strongly in the first months of the year due to a good performance of tax revenues, in particular during May. Nonetheless, the postponement of the income operation may have distorted the collection figures, so it will be necessary to know the data for May to have a more conclusive outlook. Thus, we estimate that revenues will be higher than previously projected - although lower than expected in the second quarter Public Finances Report - leading to a deficit of around 0.5% of GDP this year, considerably lower than estimated at the beginning of the year.

Tax revenues have been historically high...



Source: DIPRES and Santander

... which allows the projected deficit to be lowered and buffers to be increased despite higher spending.



Source: DIPRES and Santander

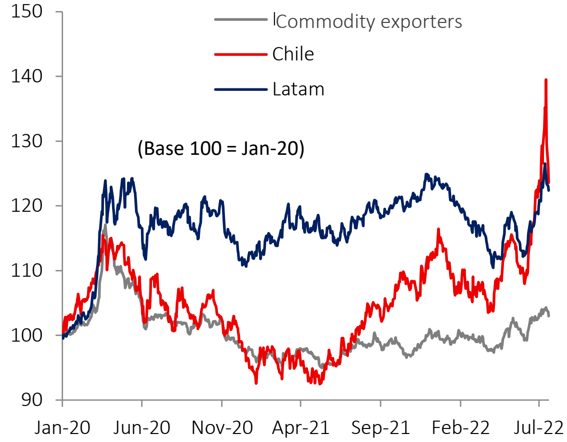
Significant exchange rate correction after Central Bank intervention

During the month, financial markets were again subject to high volatility, particularly the exchange rate. The parity rose significantly, driven by both the sharp fall in copper prices and the global strengthening of the dollar. Nevertheless, there were also speculative movements associated both with the short-term dynamics of the currency and the confusion that various statements by the authorities may have generated.

In this scenario, the exchange rate surpassed the $1,000 barrier and was clearly above its fundamentals, with a deviation of close to 10% (see Technical Note: The nominal equilibrium exchange rate). Against this background, the Central Bank decided to conduct foreign exchange intervention of up to US$25 billion, with spot and derivative sales together with a currency swap programme. Spot sales would be up to US$10 billion, which could result in a drop of up to 25% in international reserves. Post-intervention currency movements have shown that the intervention was successful. As a result, the Peso has appreciated by 11% to $930, returning to levels consistent with its fundamentals.

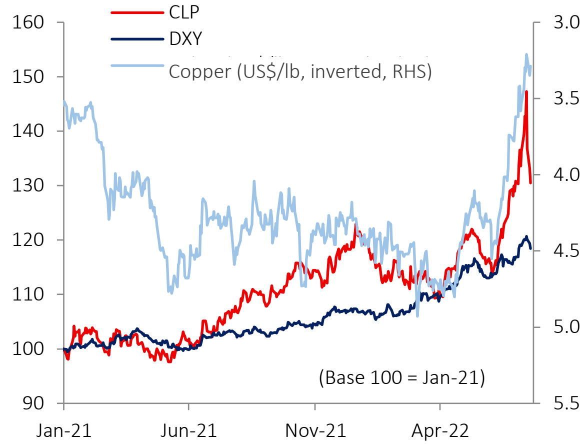
In the future, the exchange rate will continue to fluctuate in line with external factors and the local political scene. In our baseline scenario, we expect some recovery in the copper price by the end of 2022 and a somewhat stronger dollar, which would lead to the exchange rate closing the year in a range between $900 and $950.

Exchange rate rises more than in similar currencies



Source: Bloomberg and Santander

After foreign exchange intervention, it returns to values consistent with fundamentals



Source: Bloomberg and Santander

Contrasting with the currency, both the local stock and bond markets were relatively stable during the month. The local stock index IPSA, after ending June with falls in line with the main global stock market indices, began a tentative recovery this month that has led it to surpass 5,000 points (2% MoM).

Interest rates have seen limited movements due to the low liquidity and the impact of counterbalancing forces. On the one hand, they have tended to relent to the global rates due to reduced growth prospects, while, on the other hand, sharper inflationary pressures and a higher country risk premium are taking place. Thus, as of the date this report was issued, the BTP10 stood at 6.6%, unchanged from a month earlier, while the BTU10 stood at 1.8%, down 26 bps.

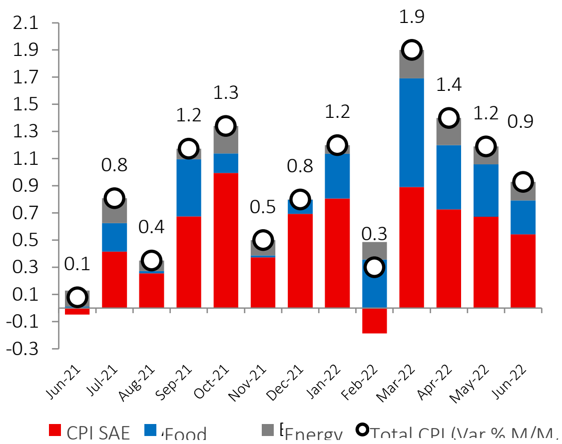
High CPI in June raises inflation again

While the CPI for June was lower than expected (0.9% vs 1.1% Santander; 1.1% Bloomberg), the reading was well above historical values for the month (0.1% average 2014-2021), where traditionally, the seasonality pushes figures downwards. This drove the annual change in the CPI to 12.5%, the highest since mid-1994.

Underlying measures, although somewhat lower, were also elevated (CPI excluding food and energy: 0.8% MoM and 9.9 YoY; CPI non-volatile: 0.7% MoM and 9.9 YoY), reflecting more persistent and widespread pressures, as was also revealed by the inflation diffusion index which, although declining, was well above the peak of recent years.

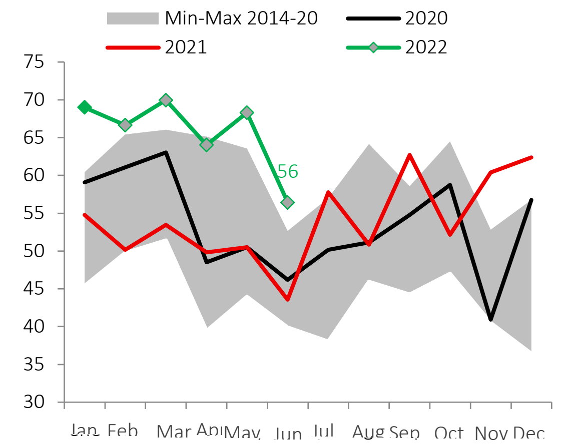
In the remainder of the year, the CPI will be driven by opposing forces. On the one hand, the sharp depreciation of the Peso in recent weeks and the second-round effects of previous price hikes will continue to exert upward pressure. On the other hand, the fall in global commodity prices and the local economy' contain future increments. The former will tend to predominate in the short term, so we will continue to see high monthly CPI changes until at least September. Towards the end of the year, we will start to see a moderation in rises, which will carry over into 2023. Based on this, we revise our inflation projection upwards for the year to 12%.

Food and energy remain important components of the monthly change in the CPI.



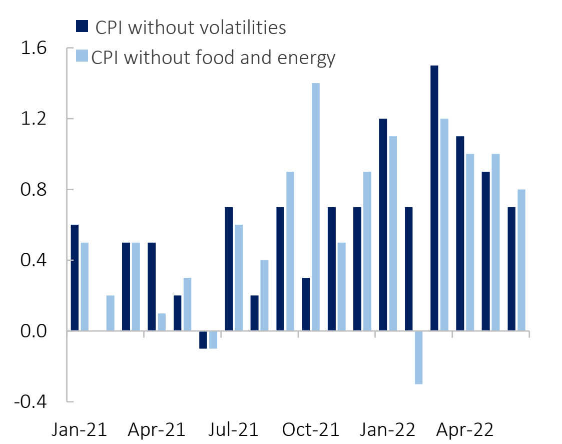
Source: National Institute of Statistics, Central Bank and Santander

More than half of the food basket shows price increases



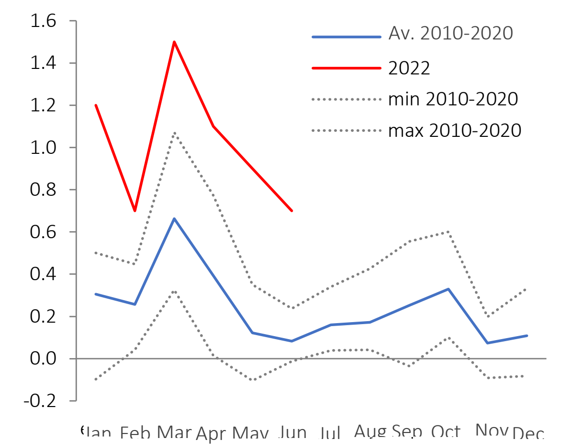
Source: National Institute of Statistics and Santander

Underlying price measures remain elevated...



Source: National Institute of Statistics, Central Bank and Santander

... above historical highs



Source: National Institute of Statistics, Central Bank and Santander

The end of the rate hike cycle is delayed

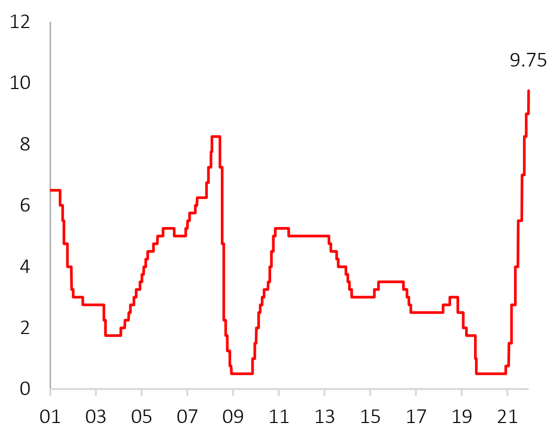
"The macroeconomic scenario presents elevated risks". This is how the Central Bank started the forward guidance of the July Monetary Policy Meeting, in which it raised the MPR by 75 bps to 9.75%. This again confirms that short-term inflation will be higher than expected and that further rate hikes will be necessary to bring inflation towards the target. Therefore, the end of the hiking cycle, which we had expected to be completed at this meeting or - at the latest - in September, is likely to be delayed until October.

As a result, we expect further MPR movements to be limited in time as a scenario of lower medium-term inflationary pressures begins to take shape due to the deterioration of the external macroeconomic landscape and the weakening of the domestic economy.

Therefore, we foresee that the MPR could rise by another 50 bps in September, and if there is evidence that inflationary registers or the activity do not diminish, a further 25 bps hike is possible in October. After that, the MPR will remain stable between 10.25% and 10.5% until the end of the year.

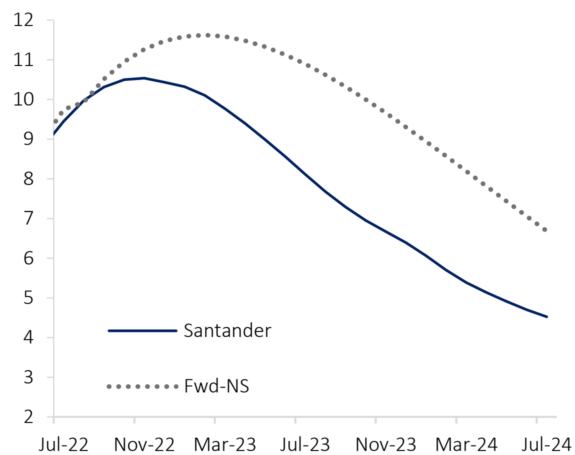
The sharper economic adjustment in 2023 would allow the Council to start the process of rate cuts from the first quarter of next year. Therefore, our view is somewhat more dovish than that implied by market prices, which forecast that the MPR could close this year at around 11% and then decline very gradually in 2023.

MPR reaches an all-time high of 9.75%...



Source: Central Bank and Santander

...and will continue to rise to a maximum range of 10.25% to 10.5%.



Source: Central Bank, Bloomberg and Santander

Macroeconomic Projections

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	302.0	310.0
GDP per capita (US$ thousand)	13.7	15.0	15.8	14.6	13.0	16.1	15.3	15.5
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	9.0	10.7
Exports (US$ billion)	60.8	68.9	74.8	68.8	73.1	94.7	96.0	88.6
Imports (US$ billion)	55.8	61.4	70.4	65.8	55.1	84.1	87.0	77.9
Current account (US$ billion)	-6.5	-7.6	-13.3	-14.5	-4.3	-20.3	-18.0	-10.3
Current account (GDP%)	-2.6	-2.8	-4.6	-5.2	-1.7	-6.6	-6.0	-3.3
Copper price (annual average US$/lb)	2.2	2.8	3.0	2.7	2.8	4.2	3.9	3.5
WTI oil price (annual average US$/bbl)	43.2	50.9	64.8	57.0	39.0	68.0	101.0	87.0

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	12.0	5.8
CPI Inflation (var. YoY % average)	3.8	2.2	2.4	2.3	3.0	4.5	11.4	8.1
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	8.6	6.0
CLP/US$ exchange rate (annual exercise)	667	615	696	745	711	852	925	935
CLP/US$ exchange rate (year average)	677	649	640	703	792	759	880	930
Monetary policy rate (%, year average)	3.5	2.5	2.8	1.8	0.5	4.0	10.5	6.5
Monetary policy rate (%, year average)	3.5	2.7	2.5	2.5	0.8	1.2	8.4	8.5

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	-24.5	1.8
Central Government balance (% GDP)	-2.7	-2.8	-1.7	-2.9	-7.3	-7.3	-0.5	-2.8
Central Gov. gross Debt (US$ billion)	53.4	68.9	70.2	74.4	91.6	102.0	115.7	125.6

CONTACT

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