A tipping point for inflation?

The low CPI in the US, combined with further corrections in oil and food prices, could be forecasting decisive points for global inflation. Nevertheless, the strength of the US labour market offers a note of caution.

Highlights

- **In the US, the CPI for July surprises on the downside with a null change.** Added to further declines in fuel and grain prices, this has led markets to expect a break in the inflationary trend and a possible early end to the Fed's rate hikes. Nevertheless, the strong dynamism in the US job creation provides a note of caution.

- **The possibility of a less restrictive global monetary policy bolsters markets.** As a result, the dollar has strengthened internationally, interest rates are falling, and stock markets are rising across the board amid an increased risk appetite.

- **China's economy is a cause for concern.** Tensions between China and Taiwan and the problems the Chinese real estate sector faces raise fears of a sharper moderation in growth. The Central Bank of China has responded by relaxing the monetary policy, cutting its benchmark rate by 10 basis points.

- **Economic activity in Chile was flat in the second quarter.** Private consumption contracted sharply, and investment fell for the second consecutive quarter. Against the new background, we estimate a 1.75% GDP growth in 2022, and we project a contraction of 1% in 2023.

- **The current account deficit widens and reaches historic levels (8.5% of GDP).** Important factors behind the deterioration are high import prices and high foreign revenues. In the future, the deficit should recede as prices normalise and domestic demand continues to moderate.

- **Inflation will continue to rise in the short term.** The CPI for July (1.4%) surprised on the upside and confirmed that inflationary pressures remain elevated. We expect the CPI to register high records in the next two months and then, during the fourth quarter, to begin to ease and close the year with an annual change of between 12% and 12.5%.

- **The Central Bank will raise the MPR again in the next meetings but should moderate momentum.** Elevated short-term inflationary pressures and expectations well above target will prompt the Board to raise the MPR by 50-75 basis points in September. It could rise again in October, but a pause should begin in December, bringing the rate to close the hiking cycle between 10.5% and 11%.

CLAUDIO SOTO
Chief Economist
claudio.soto.gamboa@santander.cl

LORENA PALOMEQUE
Economist
lorena.palomeque@santander.cl

CARMEN GLORIA SILVA
Economist
carmengloria.silva@santander.cl

MIGUEL SANTANA
Economist
miguelpatricio.santana@santander.cl

RODRIGO CRUZ
Economist
rodrigo.cruz@santander.cl

Lower inflation in the US prompts global markets to expect a moderation in rate hikes

The surprising July inflation data in the US (CPI MoM: 0% vs 0.2% expected) and further declines in fuel and grain prices have led markets to speculate on an early end to the Fed's rate hike process. This has led to further falls in long-term rates, the dollar remains strong internationally, and global stock indices have rebounded almost everywhere (MSCI World: +7%, MSCI Emerging Markets: +4%). Another highlight was the strong rebound in Latin American markets (+12%) due to lower risk aversion.

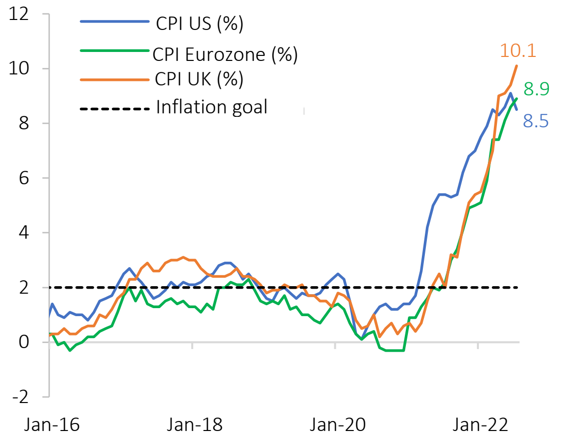
Notwithstanding, the strong buoyancy of the US labour market (non-farm payroll employment: 528 thousand vs 250 thousand expected; unemployment rate: 3.5% vs 3.6% expected) puts a note of caution on the future evolution of inflation and the Fed's upcoming decisions. After a 75 bps hike in July, consistent with expectations, Fed Chairman Jerome Powell stated in a press conference that it would be appropriate to slow the pace of hikes at some point. This moderate bias was confirmed in the meeting notes published this week. In the coming days, the focus will be on the annual symposium in Jackson Hole (25-27 August), where further forward guidance signals are expected for the last three FOMC meetings of the year.

On the political front, US President Joe Biden signed a new Inflation Reduction Act that will be funded through increased tax revenues over the next 10 years. The measure includes US$750 billion on health, taxes and climate. The country's largest investment is committed to climate, with US$370 billion allocated to reducing greenhouse gas emissions (40% reduction by 2030).

The expected increase in the European Central Bank's benchmark interest rate took place (50 bps vs 25 bps expected) after Eurozone inflation reached a record high (CPI for July: 8.9% YoY vs 8.6% previously). Nevertheless, real activity in the region has been dampened by the war in Ukraine, leading to a significant moderation (2Q22 GDP: 3.9% YoY vs 5.4% previously; retail sales in June: -3.7% YoY vs -1.7% expected). Against this background, business expectations have continued to deteriorate (August ZEW survey: -54.9 vs -51.1 previously) amid growing concerns about energy supply.

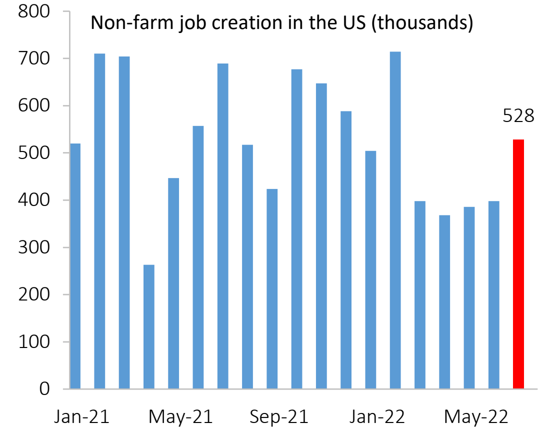
In contrast to trends in developed countries, Chinese equities declined nearly 2% during the month after a disappointing July economic data (industrial production: 3.8% YoY vs 4.3% expected; retail sales: 2.7% YoY vs 4.9% expected; manufacturing PMI: 49 vs 50.3 projected) and elevated geopolitical tensions with the US, which followed the official visit to Taiwan by the Speaker of the US House of Representatives, Nancy Pelosi. In response to the slowdown in its economy, the Chinese monetary authority cut one-year interest rates by 10 bps, signalling its willingness to provide further stimulus to the economy.

Inflation in the US is the first among developed countries to start to ease...



Source: Bloomberg and Santander

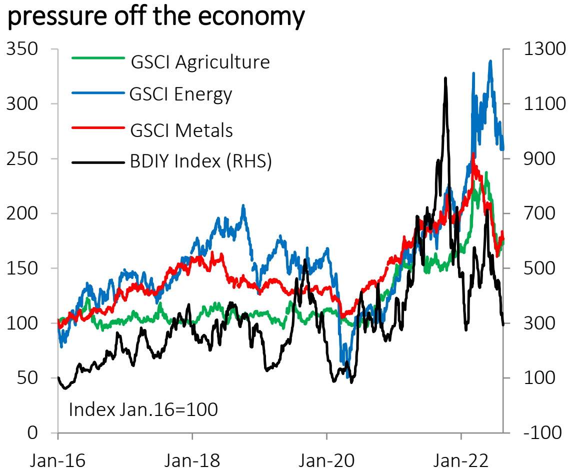
...but the labour market remains robust



Source: Bloomberg and Santander

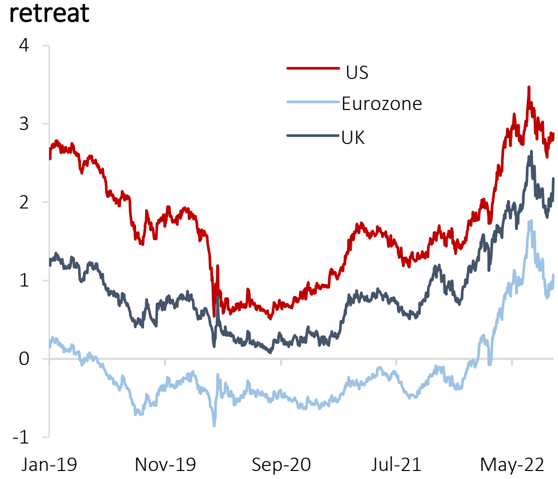
Against this background, commodity prices have seen mixed movements. Energy has continued to fall (-7% in the month), while metals and agricultural products have seen a partial recovery (7% and 1% in the month, respectively). Furthermore, ocean freight costs have also declined (Baltic Dry Index: -35%), reinforcing the view that inflationary pressures may be moderating.

Lower commodity prices will continue to take pressure off the economy



Source: Bloomberg and Santander

With ups and downs, long-term rates tend to retreat

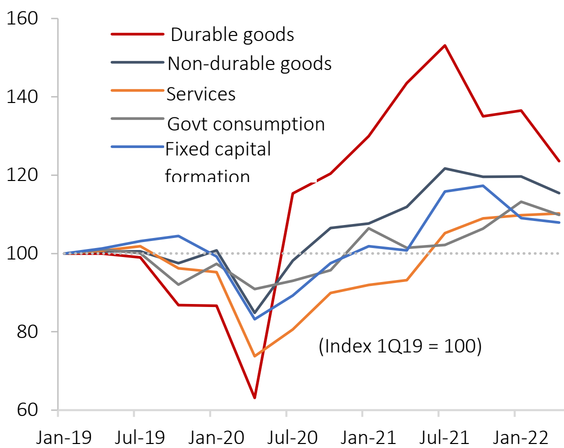


Source: Bloomberg and Santander

The loss of dynamism in the local economy has been confirmed

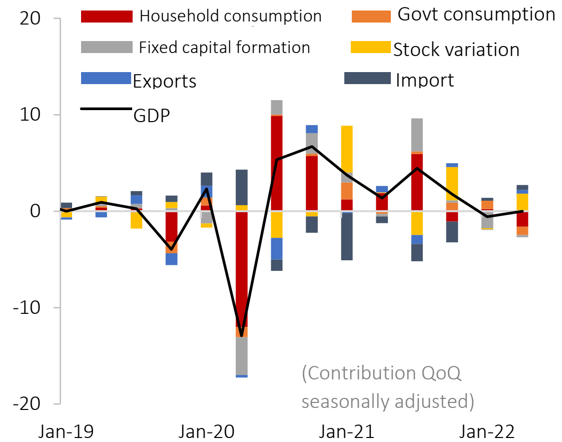
National accounts data released during the week confirmed the economic slowdown since the end of last year. Although the second quarter GDP grew by 5.4% YoY (5.7% preliminarily estimated with the Imacec), it was flat compared to the first quarter due to the severe fall in the year's first quarter. Moreover, private consumption, which had shown some resilience in the first months, contracted sharply in the second quarter (-2.4% QoQ seasonally adjusted), even though it remains at relatively high levels, above trend. On the other hand, fixed capital formation narrowed again in the second quarter, albeit with a slight expansion in the construction sector after the previous quarter's decline.

Private consumption and investment dropped compared to the previous quarter



Source: Central Bank and Santander

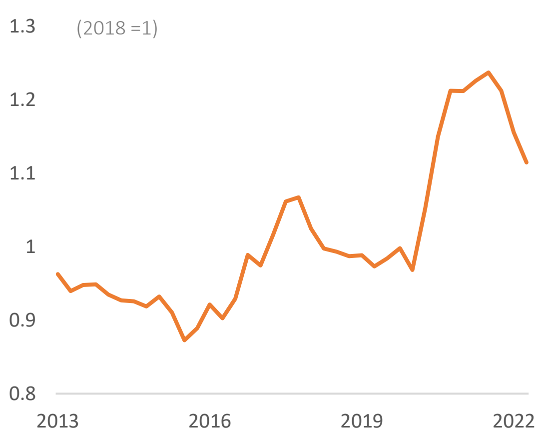
Fall in private consumption offset by a change in inventories



Source: Central Bank and Santander

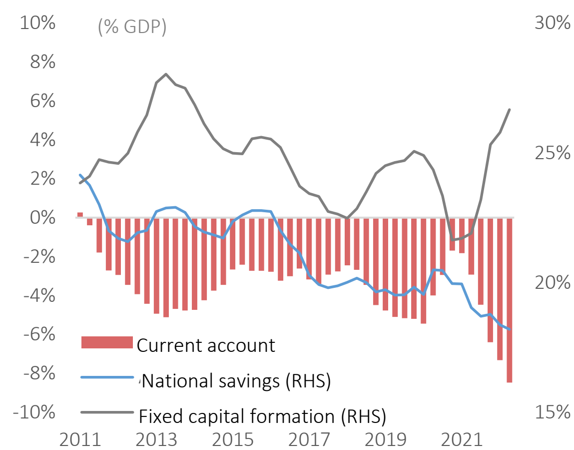
Exports of goods also declined from the previous quarter (-0.2%), mainly due to lower exports of copper (-1.8% QoQ). The export of services, meanwhile, surprised with strong growth (25.6%). As a result, exports of goods and services recovered in the period (1.6%). On the other hand, the import of goods fell compared to the previous quarter (-2%) due to the strong contraction of energy products (-10.6%) and industrial goods (-1.7%).

Terms of trade deteriorate



Source: National Institute of Statistics and Santander

Current account deficit reaches record highs

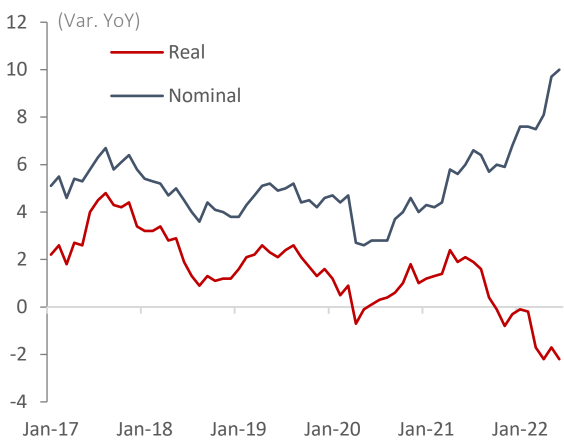


Source: Central Bank and Santander

One of the most striking data was the sharp increase in the current account deficit, which accumulated the equivalent of 8.5% of GDP in the rolling year ending in June. Behind this figure are high investment income, rising import prices and downward revisions in export prices. Nonetheless, we expect this deficit to recede in the remainder of the year as import prices decline and domestic demand moderates further. It would thus close at around 6%.

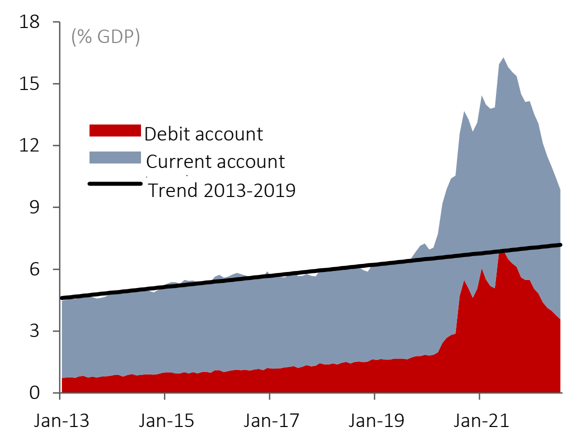
Marginal figures show that the economy enters the third quarter slightly worse than previously estimated due to lower consumption of goods (which is compensated by the improved investment situation). As a result, the seasonally adjusted non-mining Imacec was revised downwards for June, showing its second consecutive decline. The total Imacec, on the other hand, is revised downwards to present zero quarterly variation. Preliminary data for July show that the loss of dynamism has continued: imports fell by almost 7% compared to the previous month due to the contraction of imports of energy products (except diesel), capital goods and cars. On the other hand, the monthly Business Confidence Indicator (IMCE) fell back again and is well below the neutral pivot (total: 39; Without mining: 36.6).

Real wages continue their downward trend...



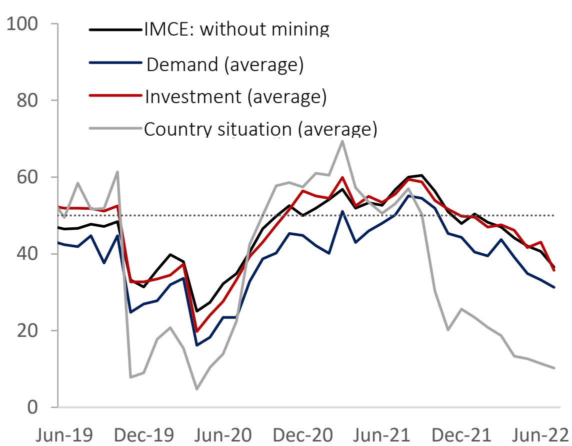
Source: Central Bank and Santander

...and liquidity continues to be drained from accounts



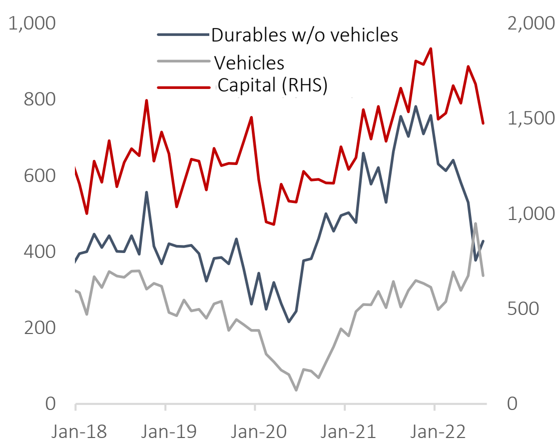
Source: Central Bank and Santander

Business confidence continues to deteriorate



Source: ICARE and Santander

Imports fall back marginally



Source: Central Bank and Santander

Local assets appreciate as copper recovers and the political scene becomes more limited

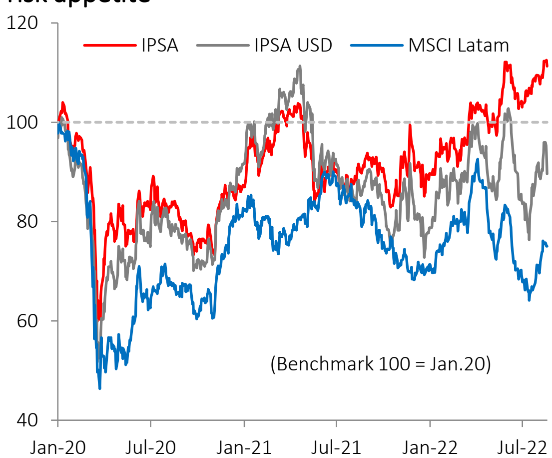
The outlook of a more moderate monetary tightening in the US underpinned some commodity prices, including copper, and lifted prices of risky financial assets globally. In Chile, the political situation remains highly uncertain regarding the results of the upcoming referendum. Nonetheless, the ruling parties' agreement on future reforms, if the 'Approve' option wins, has given certain edges to possible institutional changes.

The above, coupled with favourable corporate results in the year's first half, boosted the local stock market, which rose nearly 4% in the month (local stock index IPSA: 5,340). The Peso, meanwhile, appreciated significantly and traded below $880. This is in a context where foreign currency liquidity continued to be underpinned by the Central Bank, with dollar sales totalling US$3,625 million in the spot market and US$8,000 million in forwards. Furthermore, the Ministry of Finance held its last dollar bid on 12 August, reaching its initial sales target of US$5 billion. Nevertheless, as of the date this report was issued, the exchange rate showed a sharp upward correction to close at $929 (3.6% daily) in response to the strengthening of the global dollar (DXY: 107.1%), weak local economic data and, more importantly, the large current account deficit in the first part of the year.

In the future, the trajectory of the exchange rate will be conditional on several factors: on the one hand, if inflation in the US eases earlier than in other countries, the dollar could weaken globally, with a consequent appreciation of the Peso. On the other hand, a further decline in copper prices due to the weakness of the Chinese economy could put upward pressure on the parity. One factor that will undoubtedly be decisive is the evolution of the country's economic and political uncertainty. The results of the forthcoming constitutional referendum and its political settlements will be crucial forces for the currency's value.

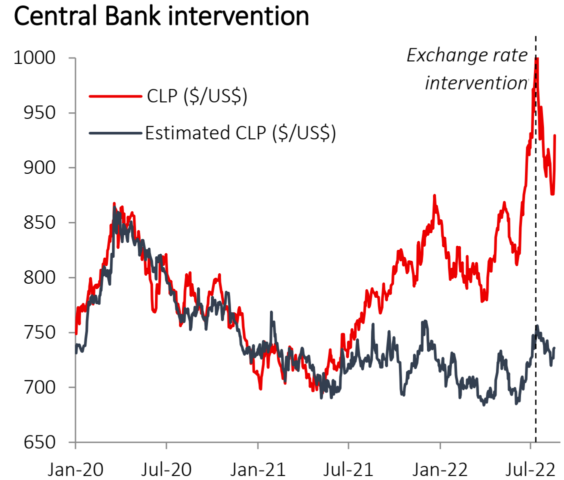
Conversely to risky assets, returns in the fixed income market have been trending upwards. At the issuance of this report, the 10-year BTU return stood at 2.3% (+47 bps for the month). In comparison, the 10-year BTP remained relatively stable at around 6.8% (+10 bps), reflecting a weaker outlook for activity and inflation over the medium term. In the international context, local rates have decoupled from downward movements, which can be explained - in part - by the evolution of the country risk premium, which, unlike its peers in the region, is at levels even higher than those of countries with lower risk ratings (CDS 5y Chile: 130 points, CDS 5y Peru: 115 points).

Local stock market rises amid increased global risk appetite



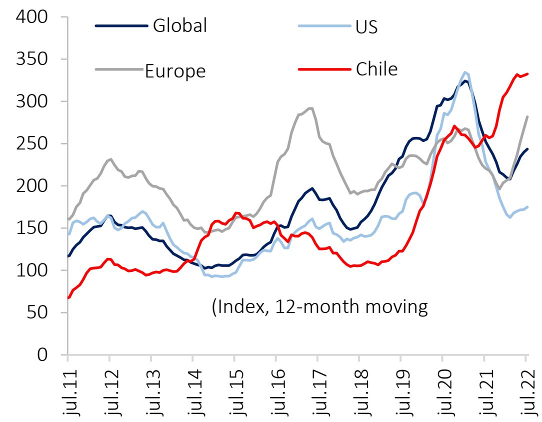
Source: Bloomberg and Santander

Exchange rate appreciates substantially after Central Bank intervention



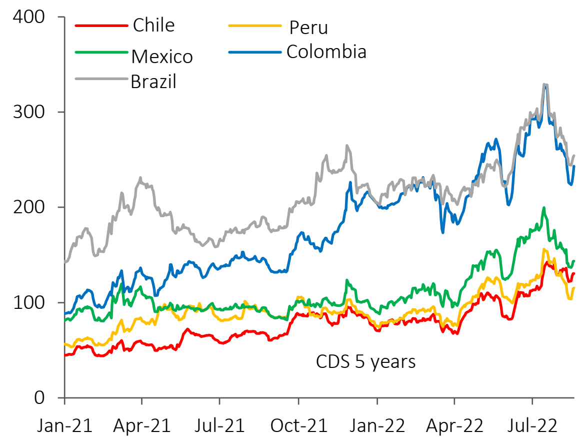
Source: Bloomberg and Santander

Economic and political uncertainty remains high



Source: Central Bank, ClapesUC and Santander

Country risk premium decreases less than regional averages



Source: Bloomberg and Santander

Inflation continues to rise

The CPI for July (1.4%) again surprised on the upside (Bloomberg: 1.3%; Santander: 1.1%), bringing its year-on-year change to 13.1% (8.5% cumulative so far this year), its highest since 1994.

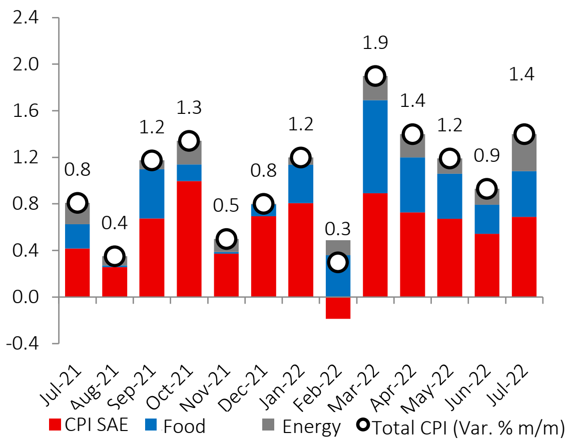
Underlying measures, while showing smaller hikes (CPI non-volatile: 0.9%; CPI excluding food and energy: 0.9%), were also high, reflecting the strong price pressures still present. Furthermore, price rises were widespread (the percentage of items in the goods basket with price lifts was 63%, above historical patterns).

Particularly noteworthy in the July increases were the divisions of transport (3.4%; incidence 0.49%) and food and non-alcoholic beverages (1.9%; incidence 0.39%). Both reported lagged effects on international food and energy prices and a higher exchange rate. In the case of transport, there were significant increases in new cars, fuels (petrol and diesel), airfares and interprovincial buses due to the seasonal effect.

Additionally, some services with a high weighting in the basket (rents and domestic services in particular) continue to show very limited variations (0% and 0.3% MoM, respectively, in July) in circumstances in which they are generally correlated with past inflation. Therefore, eventual corrections in these items represent a significant upside risk to future inflation developments.

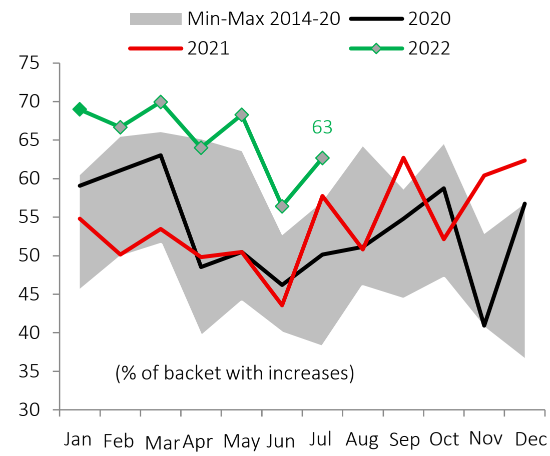
In the short term, we expect the CPI to have relevant variations in August and September (around 1%). Nevertheless, from October onwards, pressures would start to moderate, both because of the recent decline in the exchange rate and the significant fall in commodity values. Furthermore, the effects of lower domestic demand and labour market weakness will become more apparent. Therefore, we estimate that after rising to around 14%, inflation will come down and close the year at 12%.

Food and energy continue to be important contributors to the CPI variation.



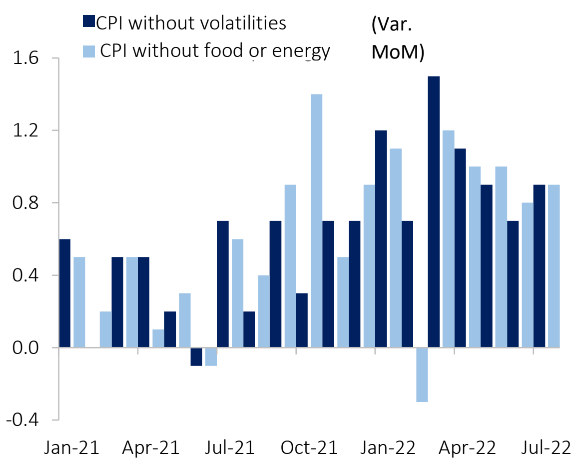
Source: National Institute of Statistics and Santander

Inflationary spread remains at recent highs



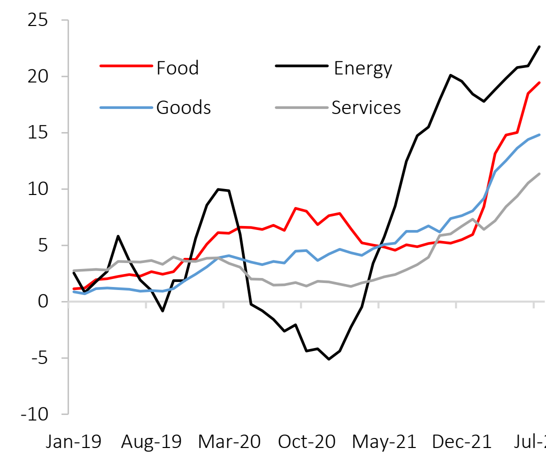
Source: National Institute of Statistics and Santander

Underlying measures show increases after three months of declines



Source: National Institute of Statistics, Central Bank and Santander

All inflation components have increased



Source: National Institute of Statistics and Santander

The Central Bank will raise its rate again in September but will moderate the tone in the future.

Although the economy has been losing momentum, consumption remains above trend, the exchange rate has tended to depreciate in recent months, and inflationary pressures are high. Therefore, it is likely that the Central Bank will continue to tighten monetary policy in the short term. Nevertheless, the cycle of hikes should be nearing its end.

At the Monetary Policy Meeting in early September, the Central Bank is expected to make its policy decision with only one additional piece of activity data - the Imacec for July - but no new inflation data (the CPI for August will be released just after the Monetary Policy Report (IPoM) is published). The Council is likely to continue to prioritise 'short-term inflationary factors', which would lead it to raise the MPR by between 50 bps and 75 bps, depending in part on the dynamics of the exchange rate in the coming weeks. It could then be raised again in October, although in a more limited manner.

The rate hike cycle would thus culminate with an MPR between 10.5% and 11%. In December, once the moderation of inflation becomes evident and activity registers negative growth figures, the Council should pause and then, during the first quarter of next year, it could begin to discuss possible reductions.

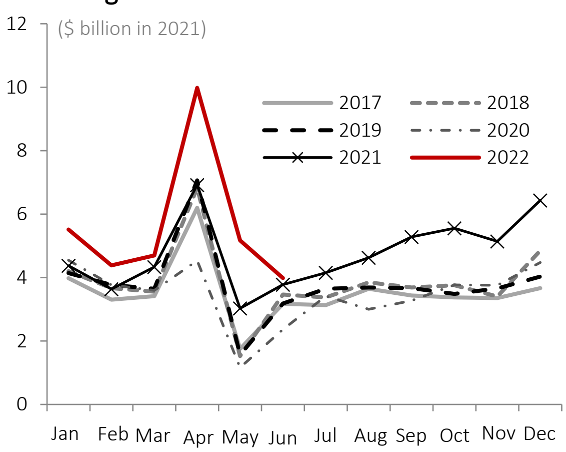
Fiscal situation improves temporarily

Despite higher spending than budgeted - due to the Chile Apoya Invierno (Chile Supports this Winter) bonus - the fiscal deficit has been reduced and is likely to end below 1% of GDP this year. This is explained by strong tax collection in the first part of the year, which boosted revenues to 21% of GDP (30% YoY in real terms in the first half of the year). Underlying this is the expiration of the deadline to benefit from the Payment of Substitutive Tax for Final Taxes (ISFUT for its acronym in Spanish) - which provoked an unprecedented income operation- and the taxes derived from the extraordinary dividend payments during the second part of 2021.

Whilst a significant part of the strong revenue collection is due to temporary factors, the methodology for calculating the cyclically adjusted balance assumes that they are structural in nature. For the same reason, the structural deficit this year will close considerably below the initial estimate of the Ministry of Finance at around 1.5%.

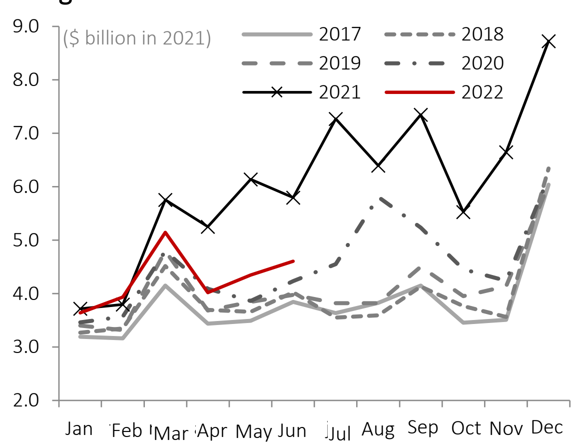
In the future, fiscal revenue projections will be very important to properly calibrate the real spending space, especially considering the macroeconomic scenario foreseen for next year, where the government will have to balance expansionary spending to stimulate the economy with the goal of fiscal consolidation and, at the same time, the inflationary pressures it could generate.

Strong revenue growth gives more room to meet fiscal target



Source: and Santander

Containing spending will be a major challenge for the government



Source: DIPRES 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	1.8	-1.0
Domestic demand (% real var. YoY)	1.9	2.9	5.0	1.0	-9.3	21.6	2.2	-2.8
Total consumption (% real var. YoY)	4.1	3.8	3.6	0.7	-7.2	18.2	2.8	-3.7
Private consumption (% real var. YoY)	3.3	3.6	3.8	0.7	-8.0	20.3	2.2	-4.5
Public consumption (% real var. YoY)	7.6	4.7	3.1	0.5	-4.0	10.3	5.1	-0.7
Gross fixed capital formation (% real var. YoY))	-2.4	-3.3	6.5	4.7	-9.3	17.6	-2.1	-4.4
Exports (% real var. YoY)	0.6	-1.0	4.9	-2.5	-1.1	-1.5	0.8	1.7
Imports (% real var. YoY)	1.2	4.5	8.6	-1.7	-12.7	31.3	2.1	-3.7
GDP (US$ billion)	249.5	276.5	296.0	279.0	253.5	316.8	303.0	304.0
GDP per capita (US$ thousand)	13.7	15.0	15.8	14.6	13.0	16.1	15.3	15.2
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	10.5	9.1	11.2
Exports (US$ billion)	60.8	68.9	74.8	68.8	74.1	94.7	96.5	88.6
Imports (US$ billion)	55.8	61.4	70.4	65.8	55.1	84.1	87.4	77.4
Current account (US$ billion)	-6.5	-7.6	-13.3	-14.5	-4.3	-20.3	-17.9	-9.8
Current account (% GDP)	-2.6	-2.8	-4.6	-5.2	-1.7	-6.6	-5.9	-3.2
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	98.0	92.0

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	12.2	5.9
CPI Inflation (% var. YoY average)	3.8	2.2	2.4	2.3	3.0	4.5	11.6	8.2
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	9.0	5.7
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	871	930
Monetary policy rate (% year average)	3.5	2.5	2.8	1.8	0.5	4.0	10.8	6.8
Monetary policy rate (% year average)	3.5	2.7	2.5	2.5	0.8	1.2	8.4	8.9

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	-23.0	1.0
Central Government balance (% GDP)	-2.7	-2.8	-1.7	-2.9	-7.3	-7.3	-0.7	-1.5
Central Gov. gross Debt (US$ billion)	53.4	68.9	70.2	74.4	91.6	102.0	114.5	117.0